Supreme Court, U.S.
FILED
JUL 25 1995
CLERK

No. 95-154 (1)

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

v.

Petitioners,

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI
and
APPENDIX, VOLUME I – App. 1 through App. 195

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QUESTIONS PRESENTED

(1) Where it is alleged that an auditor violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder (collectively, "§ 10(b)") by knowingly and recklessly certifying fraudulent financial statements, can the auditor "conclusively rebut" *scienter*, and thereby obtain summary judgment, merely by submitting declarations attesting that its accounting and auditing determinations were reasonable, despite contrary evidence, including expert testimony, demonstrating that the auditor knowingly and recklessly violated applicable accounting and auditing standards? Do cases involving accounting issues present an exception to the general rule in § 10(b) cases that summary judgment is improper if the plaintiff submits evidence from which the trier-of-fact could reasonably infer that the defendant intentionally, knowingly or recklessly disseminated false or misleading statements?

(2) Where a public company issues securities, are the company, its senior executives, directors and underwriters immunized from liability under §§ 11 and 12(2) of the Securities Act of 1933 (the "Securities Act") and § 10(b) for material misrepresentations or omissions of existing facts, pursuant to the so-called "bespeaks caution doctrine", merely because the offering documents also disclose a risk that certain adverse events may occur in the future? Is the "bespeaks caution doctrine", as enunciated and applied by the Ninth Circuit, consistent with this Court's decision in *Virginia*

QUESTIONS PRESENTED – Continued

Bankshares v. Sandberg, 501 U.S. 1083 (1991), and with historic precedent regarding materiality and adequacy of disclosure under the federal securities laws?

(3) Can corporate officers, directors and others "conclusively rebut" scienter by declarations or affidavits, and thereby obtain summary judgment on a § 10(b) claim, in the face of evidence that they knowingly or recklessly disseminated materially false and misleading representations to the investing public or engaged in insider trading of securities with knowledge of material adverse information?

(4) Can a court, consistent with the Seventh Amendment to the U.S. Constitution and Rule 56 of the Federal Rules of Civil Procedure ("Rule 56"), disregard evidence submitted by the nonmoving party and refuse to draw justifiable inferences in favor of the nonmoving party when considering a motion for summary judgment? Do the Seventh Amendment and Rule 56 permit the court to make determinations regarding the credibility of witnesses and to weigh the nonmoving party's evidence against the evidence submitted by the moving party?

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I. OPINIONS BELOW

The opinion of which review is sought is published at 35 F.3d 1407 (9th Cir. 1994) ("*WOW II*"). *See* Appendix at pg. App. 1. *WOW II* affirmed in part and reversed and remanded in part a district court opinion, published at 814 F. Supp. 850 (N.D. Cal. 1993) ("*WOW I*"), which granted summary judgment to all defendants on all claims. Other published district court opinions in this case include: (1) Opinions on motions to dismiss, published at 694 F. Supp. 1427 (N.D.Cal. 1988) and 721 F. Supp. 1140 (N.D.Cal. 1989); (2) Opinion granting class certification, published at [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,004, 1990 WL 61951 (N.D.Cal. 1989); (3) Opinion on motions for partial summary judgment, published at [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689, 1990 WL 260675 (N.D.Cal. 1990); and (4) Decisions on discovery motions, published at 147 F.R.D. 208 (N.D.Cal. 1992), 147 F.R.D. 214 (N.D.Cal. 1992) and [1992 Transfer Binder] Fed. Sec. L. Rep. ¶ 97,018, 1992 WL 330411 (N.D.Cal. 1992).

II. JURISDICTION

Petitioners seek review, by writ of *certiorari*, of a judgment entered September 15, 1994 by the Ninth Circuit Court of Appeals. Rehearing was denied on March 27, 1995. App. 50. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

III. CONSTITUTIONAL PROVISIONS, STATUTES, RULES AND REGULATIONS INVOLVED

The following relevant constitutional provisions, statutes, rules and regulations are set forth in the Appendix: U.S. Constitution, Seventh Amendment; §§ 11, 12(2) and 15 of the Securities Act [15 U.S.C. §§ 77k, 77*l*(2) and 77o]; §§ 10(b) and 20 of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder [15 U.S.C. §§ 78j(b) and 78t, and 17 C.F.R. § 240.10b-5]; and Fed. R. Civ. Proc. 56.

IV. STATEMENT OF THE CASE

A. Introduction

The federal securities statutes are premised on the principle of full and fair disclosure to the investing public, reflecting the Congressional determination that "[t]here cannot be honest markets without honest publicity." *Basic, Inc. v. Levinson*, 485 U.S. 224, 230 (1988). To that end, §§ 11 and 12(2) of the Securities Act (hereinafter, "§ 11" and "§ 12(2)") provide a right of action for misstatements and omissions of material fact in prospectuses for public securities offerings. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983). Furthermore, § 10(b) provides both governmental authorities and private investors with a remedy for misstatements and omissions in connection with the purchase and sale of securities. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195-96 (1976). For over sixty years, the regime of investor protection embodied in the federal securities laws has fostered stability, predictability and investor confidence, and has made American capital markets the envy of the world.

The Ninth Circuit's opinion in this securities class action, to the extent that it affirms summary judgment in favor of the defendants, substantially alters the rights and duties of participants in the public securities marketplace in a manner which is inconsistent with the language and policy of the securities laws, controlling precedent of this Court thereunder and the holdings of other courts of appeals. The opinion drastically weakens investor safeguards and immunizes broad categories of dishonest, reckless or careless conduct which have historically been actionable. In so doing, it not only seriously impairs aggrieved investors' rights to obtain relief through private litigation but also jeopardizes the government's ability to protect the public from securities violators.

The Ninth Circuit's opinion requires review in several significant respects. First, that opinion conflicts with the rulings of other courts of appeals regarding the showing necessary under § 10(b) to establish a *prima facie* case of *scienter* against a public auditor. Other circuits have ruled that a jury question is presented on the issue of *scienter* where

the plaintiff offers evidence from which a reasonable trier-of-fact could conclude that an auditor intentionally, knowingly or recklessly certified materially misleading financial statements. In particular, they have held that summary judgment must be denied where the plaintiffs offer expert testimony that the auditor knowingly or recklessly violated governing accounting and auditing standards. *E.g., Fine v. American Solar King*, 919 F.2d 290 (5th Cir. 1990), *cert. dismissed*, 502 U.S. 976 (1991). *See Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994).

However, the Ninth Circuit's opinion abrogates this standard. It holds that a § 10(b) plaintiff can *never* get to the jury on the *scienter* issue, no matter how strong his evidence of fraudulent intent, knowledge or recklessness, as long as the auditor proffers expert testimony that its accounting determinations were valid. In the Court's words, the auditor's expert testimony "negates" the plaintiff's showing and compels the grant of summary judgment. The Ninth Circuit's ruling turns both § 10(b) and Rule 56 on their heads, and makes it virtually impossible for an aggrieved investor to obtain relief under § 10(b) from accountants and auditors who certify and disseminate false and misleading financial statements.

Furthermore, the Ninth Circuit's opinion improperly applies the so-called "bespeaks caution doctrine" to hold that disclosures of *potential risks* in a securities prospectus rendered the defendants' misrepresentations and omissions of *existing fact* immaterial under § 11, § 12(2) and § 10(b). The Ninth Circuit's application of the "bespeaks caution doctrine" requires review for two reasons. First, it conflicts with the holdings of other courts of appeal that the "bespeaks caution doctrine" applies only to projections and other forward-looking statements, and does not immunize misrepresentations or omissions of existing facts. *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981), *aff'd in relevant part and rev'd in part on other grds*, 459 U.S. 375 (1983). Second, the Ninth Circuit's opinion applies the "bespeaks caution doctrine" in a manner inconsistent with controlling precedent regarding materiality and adequacy of

disclosure. In *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), this Court held that cautionary disclosures do not render a misrepresentation or omission immaterial unless those disclosures are so complete, thorough and precise that they exhaust the misleading statement's capacity to deceive. Yet, the Ninth Circuit's opinion improperly applies the "bespeaks caution doctrine" as a *per se* rule, under which the mere fact that the prospectus *addressed* a particular subject automatically excuses any and all misrepresentations or omissions regarding that subject. Unless reviewed, the Ninth Circuit's application of the "bespeaks caution doctrine" will invite abuse by permitting dishonest issuers to conceal material facts behind disingenuous or incomplete disclosures of potential risks.

The Ninth Circuit's opinion also requires review in that it broadly immunizes securities issuers, their officers, directors, underwriters and controlling persons from § 10(b) liability for misstatements and insider trading. The opinion holds that such persons can "conclusively" rebut *scienter*, and thereby obtain summary judgment, by submitting declarations attesting to their good faith, by proving that their insider sales did not comprise all or substantially all of their holdings, and by showing that they disseminated a prospectus which contained "risk disclosures." This conclusion conflicts with the holdings of other circuits, the language and policy of the federal securities laws and the dictates of Rule 56.

Finally, review is necessary because, in affirming summary judgment in the defendants' favor, the Ninth Circuit has failed to conform its *de novo* review to the legal standards set forth by this Court pursuant to Rule 56 and, in so doing, has infringed the right to a jury trial guaranteed by the Seventh Amendment.

B. Statement of Facts

This case arises from the sudden, catastrophic collapse of the toy company Worlds of Wonder ("WOW"). In reliance on the success of its "Teddy Ruxpin" bear during the 1985 Christmas season, WOW "went public" on June 20, 1986.

Less than a year later, WOW, to alleviate a cash shortage, returned to the securities markets to sell $80 million of debentures in a public offering on June 4, 1987 (the "Offering").

1. The Officers' Bullish Public Statements and WOW's Sales Slowdown

In public statements made during the month immediately before the Offering, Donald Kingsborough, WOW's Chief Executive Officer, and Richard Stein, WOW's Chief Financial Officer,[1] announced that sales of WOW's principal products were either ahead of or keeping pace with the Company's internal plan and that demand for WOW's products was "very strong". They represented that Lazer Tag, the successor to Teddy Ruxpin as WOW's most important product, was "the hottest seller in the U.S.", boasting that "we've won the battle in the Lazer Tag category." Only four days before the Offering, Stein reassured investors that "we've seen no decline" in Lazer Tag sales. Kingsborough and Stein "confidently" predicted that revenues for the fiscal year ending March 31, 1988 ("FY88") would reach $500 million, and that WOW would report FY88 earnings of between $1.50 and $1.60 per share – increases of 53% and 80%, respectively, over the results reported in the fiscal year ended March 31, 1987 ("FY87"). ER 631/Exhs. 3, 4, 6, 7 (at pp. 30-31); ER 518/Exhibit 86; ER 528/Exh. A at 42736, 42746.[2]

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[1] Defendants/respondents Kingsborough, Stein, and WOW President Angelo Pezzani are collectively referred to herein as the "Officers".

[2] Citations to the Excerpts of Record in the Court of Appeals begin with the prefix, "ER", followed by the district court docket number and, if appropriate, the specific Exhibits, paragraph numbers and/or pages cited. Citations to deposition excerpts in the record before the Court of Appeals begin with the prefix, "ER", followed by the district court docket number of the document in which the deposition excerpt is to be found, the name of the deponent and the page number.

These statements were false and misleading. In fact, during the five months immediately preceding the Offering, WOW experienced a slump in sales and demand for its products which far exceeded in both magnitude and duration the post-Christmas sales decline expected by the Company. Sales in January, 1987, were less than 40% of budgeted levels, and February sales were equally poor. ER 517/Exh. 42. The trend continued in March, when WOW's auditor, Deloitte, noted a "general weakening in demand", and significantly worsened in April and May, 1987, the two months immediately preceding the Offering. ER 516/Exh. 3 at 17; ER 610 Bradlee 118; ER 519/Exh. 118. Sales from April 1 through the June 4 offering date totaled barely $7 million, only 16% of the amount budgeted for the April-June quarter, the first quarter of FY88 ("1Q88"). *Id.*; ER 520/Exh. 165.

The lawyer for WOW's underwriter, Smith Barney, learned in his "due diligence" investigation that WOW's 20 largest customers, retailers who accounted for 84% of the Company's revenues, were "sated," due to poor consumer demand and excessive unsold inventories of WOW products. ER 519/Exh. 119 at 21288. The outlook for the remainder of the year was even worse: by late April, 1987, by which time 90% of the orders for the year should have been received, WOW had received orders consistent with FY88 revenues of only $200 million, far less than the publicly projected $500 million. ER 610/Bruggeman 304-06, 317-18.

The collapse in sales and demand affected all of WOW's products (ER 517/Exh. 42 at pp. 5, 17, 21); but the key Lazer Tag product line was particularly hard hit. WOW had projected $121 million in FY88 sales of Lazer Tag products. Yet, in 1Q88, WOW generated less than $1 million of revenues from Lazer Tag. Indeed, the principal toy industry trade publication reported less than one week after the Offering that Lazer Tag was a "dead" product. ER 625/Exh. A.

2. WOW's Sales Practices

The negative consequences of lagging sales and poor demand were aggravated by WOW's sales practices, which

the Company never disclosed and investors never knew about. WOW's terms of sale routinely permitted its customers rights of return, exchange or retroactive price reduction which defeated the finality of completed sales. ER 610 Whims 196; ER 544 Kingsborough 114-18; ER 514.[3] Accordingly, as consumer demand dried up, large retailers increasingly resisted paying and tried to return large quantities of WOW products which they had previously purchased. *See* App. 342-356. Thus, WOW's Collections Manager warned Kingsborough and Stein less than a month before the Offering that WOW's major customers had an "overstock problem," and observed that "[t]he single greatest issue severely impacting collections is unsold inventory on retail shelves. Numerous major accounts are withholding payment until WOW either takes back product or redates the invoices." ER 511/Exh. H.

3. Internal Controls and Management Information Systems

The difficulty in collecting receivables was aggravated by the sorry state of WOW's internal controls and management information systems ("MIS"). As Deloitte orally reported to management and the underwriters before the Offering, and confirmed in writing after the Offering, the operating disciplines normally associated with a large organization did not exist at WOW. ER 516/Exh. 2. Records were highly disorganized, quality control was ineffective, internal financial statements were unreliable, and WOW's MIS did not properly reflect receivables, inventories, liabilities, customer

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[3] All of WOW's sales included rights of "stock balancing" (an unqualified right to return or exchange product in the future if it did not sell through to consumers) and "price protection" (the right to receive a credit if WOW later lowered its prices to other customers). In addition, WOW had a "policy" of improperly recognizing revenue on "guaranteed sales" – *i.e.*, sales with a guaranteed right of return for cash or credit. ER 516/Exh. 3 at 27; ER 517/Exh. 33 at 2034-35. At least $4.1 million of WOW's reported sales in the fourth quarter of FY87 ("4Q87") – the last quarter for which results were available before the Offering – were attributable to improper "guaranteed sales." ER 514; ER 511: ¶19.

chargebacks or the true terms of sales transactions with the Company's customers. *Id.*; ER 610 Bruggeman at 18-29, 63, 94, 185, 233. In short, WOW was "out of control" at the time of the Offering – unable to "understand or control its business." *Id.*

4. Liquidity Issues

Slow sales, poor collections and WOW's lack of control over its business exacerbated the Company's cash shortage. In his notes of an April 6, 1987 Board meeting, WOW Director John Howenstine summarized CFO Stein's remarks with the words, "COMPANY DESPERATE". ER 718/Exh. 40. As the cash squeeze became more severe prior to the Offering, the Company was stringing out payments to its creditors, "juggling money from day to day". ER 610 Bodzy 379; ER 545 Tanner 379-80. The only potential source of cash was a possible public offering; but unless WOW reported acceptable results for 4Q87 – the quarter which would end on March 31, 1987, and the results of which would appear in the Prospectus – , no offering would be possible. ER 513: ¶¶ 23, 27, 113.

5. WOW's Large, Questionable Transactions

At or near the end of 4Q87, only two months before the Offering, the Officers, with Deloitte's assistance, created and implemented massive, irregular and improper transactions so that the revenue recognized thereon would enable the Company to meet its projections (ER 610 Butler 75-78), and thereby make possible a public securities offering. These transactions included the following:

The K-Mart Transaction. WOW recognized revenue in 4Q87 on a "sale" of $18.2 million of merchandise to K-Mart which purportedly occurred three days before the end of the quarter. Accounting and auditing expert Albert Rossi opined that the recognition of revenue on this huge transaction was forbidden under black-letter accounting standards for three distinct reasons. *First,* the transaction gave K-Mart various rights to return or exchange product after the "sale", but failed to satisfy the requirements for revenue recognition set

forth in the governing accounting standard, FAS 48. *See* Declaration of Albert Rossi, Jr., at ¶¶ 23-28, 46-47, reproduced in the Appendix at pp. App. 196-330. *Second,* under the Letter Agreement which governed the transaction, the goods were not shipped to K-Mart at the time of the sale, but, rather, were delivered to and stored in a WOW- controlled warehouse, at WOW's expense, and WOW retained the risk of physical loss or damage to them. *See* Letter Agreement, App. 331 . Thus, the transaction was a "bill and hold" transaction under SEC precedent, but failed to satisfy at least five of the seven requirements which the SEC has imposed for the recognition of revenue on such transactions. Rossi Decl. ¶¶ 29-35, App. 223-230. *Third,* the Letter Agreement on its face showed that it had been backdated (*See* Letter Agreement, ¶ 9, App. 333), and the goods were not shipped in time to merit revenue recognition in 4Q87. Rossi Decl. ¶¶ 36-45, 48-53, App. 231-239.

The FOB and Transfer Sales. WOW also recognized revenue in 4Q87 on massive, irregular, end-of-fiscal-year transactions with several other large customers – so-called "FOB Sales", in which product was "sold" to customers while it was still in Hong Kong or on its way to the United States; and "Transfer Sales", under which product stored in a WOW-controlled warehouse would be recharacterized as product belonging to the customer, without being physically shipped to the customer. Like the K-Mart Transaction, these were "bill and hold" transactions, but they failed to satisfy the SEC's revenue recognition criteria. Rossi Decl. ¶¶ 56-73, App. 245-256.

The Barter Deal. WOW recognized $9 million of 4Q87 revenue on a transaction with media brokers under which it bartered discontinued products in exchange for the brokers' contingent promise to give WOW discounts if the Company ever bought advertising time in the future through them. ER 517/Exh. 36. This violated applicable accounting rules in numerous respects. Rossi Decl. ¶¶ 74-82, App. 256-262.

Materiality. WOW improperly recognized over $41 million of revenue on the K-Mart Transaction, the FOB and Transfer Sales and the Barter Deal. Rossi Declaration,

¶¶ 3(a)-(b), App. 206-208. Without the questionable transactions, 4Q87 revenues would have been only $68 million, far below what WOW had projected, and WOW would have suffered a $17 million quarterly loss. With the illicit revenue, WOW was able to report 4Q87 sales of over $109 million and a quarterly profit. Had these revenues not been recognized in 4Q87, WOW's reported results would have been so poor that the Offering could not have gone forward. ER 513: ¶¶ 23, 27, 113.[4]

Deloitte's Knowledge and Recklessness. Deloitte concedes, and the auditors' workpapers show, that the auditors knew the salient facts about the K-Mart, FOB, Transfer and Barter deals. Morever, they knew the transactions were highly dubious. Indeed, Deloitte auditor William McKee concluded, from the terms of these transactions, that "*management appears willing to undertake unusual and potentially improper methods to maximize sales.*" ER 516/Exh. 4 at p. 2. From the auditors' knowledge, and from their shoddy, pretextual audit analysis, a trier-of-fact could conclude, and Mr. Rossi opined, that the auditors knew the FY87 financial statements were false (Rossi Decl., ¶ 5, App. 210); that their conduct of the audit was reckless, constituting an extreme departure from the standard of ordinary care (*Id.*, ¶¶ 4(a), 22, 54(c), 55, 60, 69, 73, 82, 83, 87, 100, 106; and that no reasonable auditor would have made the accounting determinations that Deloitte did. *Id.*, ¶¶ 11, 57, 142, App. 213, 246, 307.

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[4] In addition to the improper recognition of revenues, WOW's FY87 audited financial statements were deficient and misleading in numerous other respects as well – they understated inventory reserves; improperly failed to include a "going concern" qualification; failed to disclose or properly account for sales made with guaranteed rights of return, exchange or "price protection"; and did not disclose a material change accounting policies which inflated WOW's FY87 pretax earnings by approximately $2.5 million. Rossi Decl. ¶¶83-115, 143-165, App. 264-292, 308-320.

6. The Prospectus

The Prospectus for the Offering (the "Prospectus") not only failed to disclose but actively misrepresented key facts about the Company and its business. App. 67.

Sales and Demand. The Prospectus did nothing to dispel the bullish impression left by Kingsborough's and Stein's pre-Offering statements regarding sales and demand. To the contrary, it represented that Lazer Tag had been the "most successful" of the Company's toy lines introduced in fiscal 1987. App. 74, 78. Although the Prospectus generally cautioned that WOW would be adversely affected in the event of "an unanticipated shortfall in seasonal demand" (App. 82), this statement was itself a misrepresentation as it failed to disclose that the Company *had already experienced* a significant sales slowdown. The Prospectus did indicate, under the heading, "Seasonality of Quarterly Results", that due to normal seasonality in the toy industry, revenues for 1Q88, would be less than those of the prior three quarters – that is, *less than $62 million* – and that the Company anticipated a loss for that quarter. App. 82. However, it never gave any indication that the Company's revenues, with the quarter almost 75% completed, stood at *only $7 million*.

Audited Financial Statements. The Prospectus included WOW's FY87 audited financial statements, together with Deloitte's unqualified or "clean" audit opinion, which attested that the financial statements were being presented in a manner consistent with Generally Accepted Accounting Principles ("GAAP"), and that Deloitte had conducted its audit in conformity with Generally Accepted Auditing Standards ("GAAS"). The financial statements reassured investors that WOW had reported impressive sales, and had continued to operate profitably, in 4Q87. App. 176. However, as noted above, the financial statements were fraudulent.

Representations Regarding Cash Resources and Working Capital. The Prospectus also comforted investors regarding the adequacy of WOW's cash resources, stating that following the Offering, the Company would have sufficient

funds to meet its capital needs and short-term cash requirements *for the following ten months* – i.e., through March 31, 1988. App. 102. The Prospectus made clear that the $80 million proceeds of the Offering would be used to pay down the Company's bank credit lines, which would then be freed up to finance the Company's operations through the end of the next fiscal year. App. 85.

Representations Regarding Sales Practices. The Prospectus misrepresented the facts regarding WOW's sales practices. It stated that the Company's policy was to recognize revenues only upon shipment of the product (App. 185), and stated that customer purchase orders were cancelable only *prior* to shipment. App. 122. The Prospectus did not reveal that the Company extended to its customers rights of product return, exchange, or "price protection" *after* shipment.

Internal Controls and Management Information Systems. The Prospectus did not disclose that the Company's controls and MIS at the time of the Offering were a shambles. Rather, the Prospectus stated only that the "development" of such controls and systems had lagged behind the Company's growth at times in the past, and that there could be no assurance that WOW could successfully implement "enhancements" thereto in the future or that the "enhancements" would keep pace with WOW's growth. App. 84.

7. WOW's Collapse

Beginning almost immediately after the Offering, the undisclosed problems which had been in existence at the time of the Offering surfaced. Net sales in 1Q88, the quarter ending a few weeks after the Offering, were only $23 million, far below the $62 million referred to in the Prospectus and barely 50% of what the Company had projected internally. ER 516/Exh. 18. WOW's domestic sales for the quarter *decreased* by 15% over the prior-year quarter. ER 669/Exh. C.

Liquidity problems quickly overwhelmed the Company. As indicated in the Prospectus, WOW used the proceeds of the Offering to pay down its bank credit lines; but the Company was so overextended that by June 27, 1987, only sixteen

days after it received the money from the Offering, WOW had already been forced to reborrow up to and beyond the maximum on those credit lines, leaving it with no source of working capital to tide it over to the Christmas selling season. ER 519/Exh. 107 at p. 1A. Stein warned Kingsborough and Pezzani that in light of the Company's financial condition and operating plan, WOW, by November, 1987, would be *$50 million* under water, even if it obtained a renewal of its bank credit lines on the most favorable available terms. App. 341.

On August 7, 1987, WOW announced that due to a "cash squeeze", it would lay off 15% of its employees and reduce capital expenditures. Within the ten days *immediately preceding* this announcement, WOW insiders sold over 600,000 shares of WOW stock – Kingsborough sold 130,000 shares for $1.15 million; WOW director Barry Margolis sold all of his stock, 152,752 shares, for over $1 million; and director Howenstine sold 50,000 shares, for $450,000.[5] Members of Worlds of Wonder Shares Partnership ("WSP") and large shareholder Josephine Abercrombie also sold significant shares.[6] The insiders reaped huge percentage returns, based on the low acquisition prices of their shares.

The insiders sold their stock just in time. For the quarter ending September 30, 1987, WOW announced a staggering loss of $43 million, which included a special charge of $29,750,000 to cover write-downs and reserves due to "price protection," excess or overvalued inventories and uncollectible receivables. ER 631/Exh. 1 at 5510-11. WOW also wrote off or reserved *an additional* $20 million for product returns resulting from its creative sales practices. ER 519/Exh. 135. Also, during this quarter, at least $9.9 million of revenue from

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[5] Margolis and Howenstine are hereinafter referred to collectively as the "Directors".

[6] As early and substantial investors in WOW, WSP and Abercrombie (the "Venture Capitalists") were entitled to representation on the four-person WOW Board of Directors. Thus, director Barry Margolis, WSP's Managing Partner, was WSP's representative on the Board of Directors. Director John Howenstine, Abercrombie's business manager, served as her representative on the Board.

the K-Mart Transaction was reversed, at K-Mart's insistence. ER 517/Exh. 60. The Press Release announcing the quarterly results disclosed that WOW was desperately short of cash (ER 521/Exh. 197).

On December 21, 1987, WOW declared bankruptcy, without having made even the first of 50 scheduled semi-annual interest payments on the debentures. ER 517/Exh. 30. Experts brought in by the creditors reported that WOW's books and records were in disarray and that most of its receivables were uncollectible. Further massive write-offs and write-downs followed, including an *additional* $30 million write-down of Lazer Tag inventories. ER 516/Exh. 21; ER 520/Exh. 164.

C. The Proceedings Below

1. The Consolidated Class Action

In late 1987, investors in WOW stock and debentures (hereinafter, the "Investors") filed class action complaints in the district court, contending, *inter alia*, that WOW, the Officers, the Directors, Smith Barney and Deloitte had violated §§ 11 and 12(2), § 10(b) and provisions of state law by misrepresenting and concealing material facts about the Company, both in the Prospectus and in public statements made before and after the Offering.[7] In addition, the Investors sought to recover damages under § 10(b) for alleged insider trading by Kingsborough, the Directors and the Venture Capitalists.[8]

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[7] Due to WOW's bankruptcy, the allegations against it were stayed. However, the Investors also alleged, pursuant to 15 U.S.C. §§ 77o and 78t, that the Officers, Directors and Venture Capitalists were liable as "controlling persons" for WOW's securities law violations, and that the Venture Capitalists were additionally liable as "controlling persons" of the Directors.

[8] The Investors also asserted claims in the district court based on WOW's June, 1986 initial public stock offering, and named an additional defendant, Dean Witter Reynolds, Inc., which had been involved only in the 1986 transaction. However, the Investors did not appeal the grant of summary judgment on those claims, and they seek no relief from this Court

Jurisdiction in the district court was premised on 15 U.S.C. §§ 77v and 78aa, and on 28 U.S.C. §§ 1331 and 1367. On March 23, 1990, the district court granted certification of a plaintiff class.

On January 20, 1993, the district court granted summary judgment to all defendants on all claims. The Investors appealed pursuant to 28 U.S.C. § 1291. The Ninth Circuit was required to review the district court's grant of summary judgment *de novo*. *Darring v. Kincheloe*, 783 F.2d 874 (9th Cir. 1986).

2. The Ninth Circuit's Opinion

The Court of Appeals upheld the district court's judgment in Deloitte's favor with respect to the Investors' § 10(b) claims,[9] and affirmed the judgment in its entirety as to all defendants other than Deloitte.

a. The § 10(b) Claims Against Deloitte

The Ninth Circuit found that there were triable issues of fact with respect to the Investors' contention that the FY87 financial statements were materially false. Moreover, the Court acknowledged that the auditors had known all of the facts which allegedly made the financial statements misleading. *WOW II*, 35 F.3d at 1425. Nevertheless, the Court affirmed summary judgment in Deloitte's favor on the § 10(b) claim on the grounds that the record "conclusively rebutted" *scienter* as a matter of law.

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as against Dean Witter. In addition, the Investors do not seek any relief in this Court as against Robinson Interests, Inc., another entity they named as a defendant below.

[9] The Ninth Circuit reversed the district court's grant of summary judgment in favor of Deloitte on the Investors' § 11 claims and remanded those claims to the district court for trial. *WOW II*, 35 F.3d at 1422-23. The Investors believe that the Court's ruling on the § 11 claim against Deloitte was correct, and do not seek any relief from this Court with respect to that issue.

The Ninth Circuit held that to raise a triable issue of fact with respect to an auditor's *scienter*, it is not enough to show that the auditor recklessly, knowingly, *or even deliberately* certified false financial statements.[10] Rather, the Court held that *scienter* can only be proven by establishing

> that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.[11]

The declaration of the Investors' expert, Mr. Rossi, stated not only that Deloitte knowingly and recklessly violated applicable accounting and auditing standards but also that no reasonable auditor would have made the same decisions Deloitte did. Nevertheless, the Ninth Circuit held that an expert declaration such as Mr. Rossi's is insufficient to raise a triable issue of fact under the legal standard quoted above. The Court interpreted that standard to mean that regardless of what the plaintiff shows, he cannot defeat summary judgment if the auditor has come forward with the declaration of *its own* expert witness defending the reasonableness of its accounting determinations. Thus, the Court concluded that Deloitte's expert declaration "negated" the Investors' showing and compelled the affirmance of summary judgment in Deloitte's favor. *WOW II*, 35 F.3d at 1426.[12]

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[10] In support of this proposition, the Ninth Circuit relied on *Vosgerichian v. Commodore Int'l*, 832 F. Supp. 909, 915 n.8 (E.D.Pa. 1993), *vacated*, 862 F. Supp. 1371, 1378 (E.D.Pa. 1994).

[11] *WOW II*, 35 F.3d at 1426 (quoting *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992).

[12] For reasons unknown, the Ninth Circuit's discussion of Mr. Rossi's declaration has an unmistakably negative tone. It refers to Mr. Rossi as an "alleged expert", denigrates his opinions as "self-righteous" and even inexplicably characterizes his exhaustive, detailed, closely-reasoned declaration as "conclusory." Nonetheless, it must be emphasized that Mr. Rossi

b. Claims Based on the Textual Portion of the Prospectus

The Ninth Circuit also affirmed summary judgment in favor of the Officers, the Directors and Smith Barney in connection with the Investors' claims, pursuant to § 11, § 12(2) and § 10(b), that the Prospectus contained material misrepresentations and omissions.

Sales and Demand. The Court held that because disclosures in the Prospectus "bespoke caution" on the subject of sales and demand, any misrepresentations or omissions on those subjects were immaterial. The Court stated that the Investors could not complain about any failure to disclose poor sales and demand in the five months before the Offering, because the 4Q87 results were disclosed (albeit inaccurately) in the Prospectus, and because WOW's poor results in April and May, 1987 were rendered immaterial by the Prospectus disclosure that 1Q88 revenues would be less than $62 million. *WOW II*, 35 F.2d at 1419.

Furthermore, the Court concluded that there was no crisis of sales and demand that required disclosure. The Court credited the Officers' assertions that they regarded disappointing 1Q88 sales as "inconsequential" Moreover, the Court found that the Investors' evidence of a sales slowdown was conclusively rebutted by the Officers' adoption of an optimistic business plan a few days before the Offering (*WOW II*, 35 F.3d at 1419-20) – coincidentally, the same business plan that Richard Stein warned would ruin the Company.

Liquidity. The Court held that disclosures in the Prospectus "bespoke caution" on the subject of WOW's cash

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is a qualified expert whose testimony has been accepted by other courts on auditing and accounting issues. *See, e.g., In re Consolidated Capital Securities Litigation*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,238, at 96,054 (N.D. Cal. 1990). The defendants here did not challenge his competence to testify as an expert and made no effort to strike his declaration. Moreover, the district court expressly held that Mr. Rossi's declaration had been admitted in evidence and considered. *WOW I*, 814 F. Supp. at 878.

resources. As a result, the Court concluded, the affirmative representation in the Prospectus that WOW would have sufficient cash to last for ten months after the Offering was immaterial as a matter of law. *Id.* The Court pointed specifically to disclosures in the Prospectus that the Company had historically experienced a negative cash flow; that it had borrowed to the limit on its bank lines *prior to* the Offering; that it would have to borrow additional money on those lines after paying them down with the proceeds of the Offering; and that it might experience problems in the event of an "unanticipated" sales decline. However, the Court made no attempt to analyze whether these disclosures put investors on notice that WOW's cash resources *immediately after* receiving the $80 million proceeds of the Offering would be inadequate. Instead, the Court applied the "bespeaks caution doctrine" as a *per se* rule, holding that because the Prospectus made some cautionary disclosures about the Company's cash resources, no omission or misrepresentation on that subject could mislead a reasonable investor as a matter of law.

The Court also dismissed the Investors' evidence of an undisclosed liquidity problem. The Court held that any possible inference of a cash shortage was negated by the fact that WOW's principal bank lender, after an investigation, renewed its credit line in September, 1987, nearly four months after the Offering. The Court presumed that no bank would renew a credit line for a company with liquidity problems, and therefore concluded that WOW did not have any such problems. *WOW II*, 35 F.3d at 1416. The Court's holding ignored the evidence that WOW's top officers knew in late June that even with a bank line renewal, the Company would be $50 million under water, and further disregarded the Company's August 7, 1987 announcement that it was suffering a "cash squeeze".

Internal Controls. The Ninth Circuit's resolution of the internal controls issue was similar. First, the Court found that the Prospectus "bespoke caution" on the issue of WOW's internal controls by warning that the Company's *attempt to improve internal controls in the future* could prove to be inadequate, and thereby rendered immaterial the undisclosed

information that WOW's *existing* controls were a shambles and that it "could neither understand nor control its business."

As with the sales and liquidity issues, the Ninth Circuit further held that there was no existing problem with controls which required disclosure. The Court found it dispositive that although Deloitte had found that WOW had "significant problems" relating to controls, Deloitte had not characterized them for accounting purposes as "material weaknesses". Furthermore, the Court held that, as a matter of law, even serious internal controls deficiencies "probably" do not have to be disclosed. *WOW II*, 35 F.3d at 1417.

Questionable Sales Practices. The Court rejected the claims based on the nondisclosure of WOW's questionable sales practices. The Court held (without record support) that price protection and stock balancing did not have to be disclosed because the market already knew about them. And, the Court held that the practice of extending guaranteed sales did not require disclosure because the over $4.1 million of guaranteed sales in 4Q87 were not material. *WOW II*, 35 F.3d at 1417-18.

c. § 10(b) Claims Against the Officers, Directors and Venture Capitalists Based on Non-Prospectus Representations

Finally, the Ninth Circuit affirmed summary judgment on the Investors' § 10(b) claims against the Officers, Directors and Venture Capitalists for insider trading and their claims against corporate insiders for fraudulent pre- and post-Offering statements. *WOW II*, 35 F.3d at 1424-28. The court held that the record "conclusively rebutted" *scienter* as to these defendants. *First*, the Court held that the presence of risk disclosures in the Prospectus "negated" any possible inference of fraud. *Second*, the Court held that *scienter* was rebutted by the fact that the Officers, Directors and Venture Capitalists (other than Margolis and WSP) did not sell all or substantially all of their stock. *Third*, the Court found that the Officers could not have committed fraud because the corporation continued after the

Offering to spend money on product development and advertising. *Finally,* the Court credited the Venture Capitalists' explanations for their stock sales, disregarding the fact that a significant amount of those sales were made immediately before WOW's announcement that it was suffering from a "cash squeeze".

V. ARGUMENT

A. The Ninth Circuit's Rulings Regarding Auditor Liability Under § 10(b) Require Review By This Court

A writ of *certiorari* should be granted to review the Ninth Circuit's holding that evidence of knowing or reckless violations of GAAP and GAAS is insufficient to raise a triable issue regarding an auditor's *scienter*, and its ruling that conflicting expert declarations require the entry of summary judgment in the auditor's favor. These rulings directly contravene the holdings of other circuits, are inconsistent with the language and policy of § 10(b) and Rule 56, and threaten negative consequences for the integrity of securities markets.

To prove *scienter* under § 10(b), it is not necessary to show that the defendant had a specific intent to defraud.[13] To the contrary, at least ten courts of appeal have held that a § 10(b) plaintiff can establish a *prima facie* case of *scienter* by showing that the defendant acted intentionally, knowingly or recklessly.[14] Moreover, this Court has made clear that because direct evidence of a defendant's state of mind will seldom be available, proof of *scienter* "is often a matter of inference from

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[13] *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 197 (§ 10(b) proscribes "knowing" as well as intentional misconduct).

[14] A majority of the circuits have held that "a highly unreasonable omission or misrepresentation involving . . . an extreme departure from the standards of ordinary care" constitutes reckless conduct under §10(b). *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 n.6 (9th Cir. 1990) (*en banc*), *cert. denied*, 499 U.S. 976 (1991) (collecting cases).

circumstantial evidence". *Herman & MacLean v. Huddleston*, 459 U.S. at 390-91 n.30.

The showing necessary to state a *prima facie* case against an auditor is no more stringent than for any other § 10(b) defendant. Thus, other courts of appeal have held that a *prima facie* case against an auditor or other public accountant under § 10(b) is established by showing that the auditor certified materially false financial statements either recklessly or with knowledge of the facts which render them misleading. *E.g.*, *Fine, supra; Sirota v. Solitron Devices*, 673 F.2d 566, 575-76 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976); *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). *Accord Endo v. Albertine*, 863 F. Supp. 708, 728 n. 41 (N. D. Ill. 1994).

It is further well-established that a triable issue of fact arises regarding an auditor's *scienter* where the plaintiff offers the testimony of an accounting expert that the auditor knowingly or recklessly certified financial statements in violation of GAAP and conducted his audit without complying with GAAS. *Fine*, 919 F.2d at 294-97; *Simon*, 425 F.2d at 805-08. *Accord Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314 (S.D.N.Y. 1982). *See Malone v. Microdyne Corp.*, 26 F.2d 471 (4th Cir. 1994) (accounting expert's testimony that financial statements violated FAS 48 raised triable issues of fact precluding directed verdict). Accordingly, where the plaintiff supports his case with the competent, admissible testimony of an expert witness attesting that the auditor violated GAAP and GAAS, the auditor cannot obtain summary judgment on the issue of *scienter*, even if he presents testimony from an expert witness of his own defending the validity of his accounting determinations. *Fine*, 919 F.2d at 296-98; *Simon*, 425 F.2d at 805 (auditor's criminal conviction upheld despite the testimony of *eight* "impressive" accounting experts that his conduct was reasonable).

Thus, in *Fine, supra*, the defendant argued the very position adopted by the Ninth Circuit herein – namely, "that the disagreement between the Plaintiffs' expert and [the defendant's expert] indicates at most a difference of professional

judgment concerning the application of GAAP, and that such a dispute does not raise a triable issue concerning *scienter*." *Fine*, 919 F.2d at 297. The Fifth Circuit rejected that argument, holding that the testimony of the plaintiffs' expert that the auditor's conduct violated GAAP raised a triable issue which precluded summary judgment on the *scienter* issue. The Court held that a trial was required because "[a] reasonable jury . . . might believe the Plaintiffs' expert and find that [the auditor] knew that it was issuing a false and misleading report, or that it was severely reckless in issuing its report." *Id.*, 919 F.2d at 298.

Ignoring these principles, the Ninth Circuit held that Deloitte "conclusively rebutted" *scienter* and that the declaration of Deloitte's expert witness "negated" the Investors' evidence, despite (1) Mr. Rossi's expert opinion that the financial statements violated GAAP and that Deloitte's conduct violated GAAS; (2) Mr. Rossi's opinion that Deloitte knew the financial statements were false and that its conduct was "an extreme departure from the standard of ordinary care for an accountant and auditor"; (3) Deloitte's concession that its auditors knew all the facts which the Investors contend made the financial statements misleading; and (4) direct evidence supporting *scienter*, such as the K-Mart Letter Agreement and Deloitte's audit memoranda.

The Ninth Circuit's rulings herein regarding auditor *scienter* conflict directly with the holdings of other circuits cited above, including the opinion of the Fifth Circuit in *Fine*; the Second Circuit's opinions in *Simon*, *Sirota* and *Herzfeld* and the Fourth Circuit's holding in *Malone*. The resulting conflict among the circuits regarding an important issue under the federal securities laws must be resolved by this Court.

The Ninth Circuit's rulings herein regarding auditor liability also merit review because they contravene the express provisions of both § 10(b) and Rule 56. These rulings allow auditors to avoid liability even in cases in which they *deliberately* certify false financial statements. Moreover, they permit an auditor to escape a trial despite the existence of triable

issues of fact regarding his knowledge or severe recklessness.[15] Under the Ninth Circuit's decision, whenever the auditor can find an expert witness to endorse its accounting conclusions, the auditor will obtain summary judgment. Because auditor defendants will rarely be unable to find *some* expert to support their position, they will virtually always prevail. As a result, neither the government nor private investors will be able to obtain relief against an auditor, even for egregious misconduct.

The Ninth Circuit's rulings on this issue also require review because they are wrong as a matter of policy. Audited financial statements play a pivotal role in the scheme of full disclosure under the securities laws, and auditors who certify them assume a special responsibility commensurate with their function as "public watchdogs". *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984). *Accord Fine*, 919 F.2d at 298. Yet, the Ninth Circuit has established a uniquely lenient rule for auditors which will enable them to escape liability even in cases in which they deliberately lie to the market.

Finally, the Ninth Circuit's rulings on auditor liability defeat the purpose of the securities statutes and pose a serious risk to the integrity of securities markets. § 10(b) is designed to deter fraud and wrongdoing. Yet, the Ninth Circuit's test permits – indeed, requires – courts to absolve auditors without ever examining the auditors' conduct, if the auditors have offered an expert witness's declaration supporting the reasonableness of their accounting decisions. This is at odds with the purpose of § 10(b). Self-evidently, if auditors can escape § 10(b) liability regardless of how they perform their work, the statute will not deter them from committing or permitting fraud.

Accordingly, this Court should grant a writ of *certiorari* to review the Ninth Circuit's rulings on the issue of auditor *scienter* under § 10(b).

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[15] Indeed, the test adopted by the Ninth Circuit for *scienter* (*see ante* at 16) paradoxically focuses only on reckless conduct, and does not appear to permit liability where an auditor *intentionally* or *knowingly* promulgates false financial statements.

B. The Ninth Circuit's Application of the "Bespeaks Caution Doctrine" Requires Review By This Court

Various courts of appeal have recently adopted the so-called "bespeaks caution doctrine" in cases alleging violations of the federal securities laws. *E.g., Kline v. First W. Gov't Sec.*, 24 F.3d 480, 489 (3d Cir. 1994), *cert. denied*, ___ U.S. ___, 115 S.Ct. 613 (1995); *Rubinstein v. Collins*, 20 F.3d 160, 168 (5th Cir. 1994). Although formulations of this "doctrine" vary, it essentially provides that under some circumstances, a defendant in a securities case may avoid liability for misleading projections or other forward-looking statements where the projections were accompanied by sufficient cautionary disclosures which "bespeak caution" regarding the risks that the projections may not be achieved. *Id.*

Interpreted properly, the "bespeaks caution doctrine" is merely "new nomenclature rather than [a] substantive change in the law". *In re Donald J. Trump Casino Sec. Lit.*, 7 F.3d 357, 364 (3d Cir. 1993), *cert. denied*, 114 S.Ct. 1219 (1994). It stands for nothing more than the proposition that projections and other forward-looking statements "must be analyzed in context". *Rubinstein*, 20 F.3d at 167. However, the Ninth Circuit has applied the "bespeaks caution doctrine" to this case in an overbroad manner which conflicts directly with the holdings of other courts of appeals and is inconsistent with this Court's precedents regarding the legal effects of cautionary disclosures.

1. The Ninth Circuit Has Improperly Applied the "Bespeaks Caution Doctrine" to Immunize Material Misstatements and Omissions of Existing Fact

Other courts of appeal have made clear that the "bespeaks caution doctrine" applies only to projections or other forward-looking statements. *Rubinstein*, 20 F.3d at 167;

Trump Casino, 7 F.3d at 371.[16] In other words, a securities defendant cannot escape liability for a lie or material omission about an *existing fact* merely by accompanying the lie with a statement of future risk that "bespeaks caution." As the Fifth Circuit held in *Huddleston v. Herman & MacLean*, *supra*, "[T]o caution that it is only possible for . . . unfavorable events to happen when they have already occurred is deceit." *Id.*, 640 F.2d at 544.

However, the Ninth Circuit improperly employed the "bespeaks caution doctrine" in this case to hold that the mere disclosure of possible future risks immunizes material misrepresentations and omissions of *existing facts*. Thus, for example, the Ninth Circuit's opinion holds that the disclosures in the WOW Prospectus that the Company might suffer adverse consequences if it experienced an "unanticipated seasonal decline" in sales, and that the Company could be adversely affected if its products were to lose favor in the marketplace, rendered immaterial misstatements and omissions regarding WOW's *existing* sales and demand problems. Similarly, the Ninth Circuit held that a statement that there could be "no assurance" that *future improvements* in WOW's internal controls and management information system would keep up with the Company's growth rendered immaterial the undisclosed information regarding WOW's *existing* problems with internal controls. In so doing, the Ninth Circuit has applied the "bespeaks caution doctrine" in a manner inconsistent with the other circuits. This Court's intervention is necessary to resolve the conflict between the circuits.

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[16] Numerous district courts have come to the same conclusion. *See, e.g., Pearl v. Geriatric & Medical Centers, Inc.*, 1995 U.S.Dist. LEXIS 5475 at *7 (E.D.Pa. Apr. 21, 1995); *Upton v. McKerrow*, 1995 U.S.Dist. LEXIS 7945 at *16 (D.Ga. Mar. 31, 1995); *In re Regeneron Pharmaceuticals Sec. Lit.*, 1995 U.S.Dist. LEXIS 4023 at *14-*15, [Current Binder] Fed.Sec.L.Rep. (CCH) ¶98,637 (S.D.N.Y. Mar. 10, 1995); *Ballan v. Upjohn Co.*, 814 F. Supp. 1375, 1382 (W.D.Mich. 1992).

2. The Ninth Circuit Has Applied the "Bespeaks Caution Doctrine" in a Manner Inconsistent with This Court's Precedent Regarding Adequacy of Disclosure and Materiality

This Court has held that the adequacy of disclosures is a "delicate" question which depends on whether, in light of the disclosures, the information omitted or misrepresented by the defendant would be *material* to a reasonable investor. *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 450 (1976). Therefore, cautionary disclosures do not excuse false statements under the federal securities laws unless the disclosures are so complete, thorough and precise that they "exhaust" the false statement's capacity to influence a reasonable investor. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 115 L.Ed.2d 929, 948 (1991). *Accord Rubinstein*, 20 F.3d at 167-68; *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir. 1993). *See Pommer v. Medtest, Inc.*, 961 F.2d 620, 624 (7th Cir. 1992) (Easterbrook, J.) ("An issuer needs to disclose the truth clearly before a lie becomes immaterial . . . . It is not enough that the other party must have recognized a risk. Risks are ubiquitous.") Yet, despite paying lip service to *Virginia Bankshares* and the principles announced therein, the Ninth Circuit *applied* the "bespeaks caution doctrine" as a *per se* rule, under which the mere fact that the Prospectus *addressed* a particular subject foreclosed any claim that the Prospectus was misleading with respect to that subject. *See* discussion, *ante*, at 17-19. The Ninth Circuit's treatment of this issue was inconsistent with *TSC* and *Virginia Bankshares*, and with the opinions of the Fifth, Sixth and Seventh Circuits in *Rubinstein, Mayer* and *Pommer*. Review should be granted to resolve this conflict and to determine whether, and to what extent, the "bespeaks caution doctrine" is applicable to cases of this type.

C. This Court Should Review the Holding that *Scienter* Can Be "Conclusively Rebutted" by Corporate Insiders in the Manner Suggested in the Ninth Circuit's Opinion

This Court should also review the Ninth Circuit's rulings with regard to *scienter* in connection with the § 10(b) claims against the Officers, Directors and Venture Capitalists. *Scienter* is a fact-specific issue on which summary judgment is generally inappropriate.[17] The Investors submitted substantial evidence which raises a triable issue regarding the *scienter* of the Officers, Directors and Venture Capitalists. *First,* they proved that Officers Kingsborough and Stein knowingly made false public statements regarding WOW's sales and demand for its products immediately before the Offering. *Second,* they demonstrated that Kingsborough, the Directors and the Venture Capitalists sold massive quantities of WOW stock mere days before WOW's August 7, 1987 public announcement that it was suffering a "cash squeeze" and would have to lay off 15% of its workforce. *Third,* they established that the Officers and Directors signed and disseminated a materially misleading prospectus which failed to disclose material adverse facts known to them. *Finally,* they showed that the Officers deliberately created, and the Directors were aware of, bogus financial transactions which were not accurately disclosed in the Company's financial statements.

The Ninth Circuit's holding that the Officers, Director and Venture Capitalist Defendants "conclusively rebutted" *scienter* despite this evidence conflicts with the holdings of other circuits and with controlling precedent of this Court.

First, the Ninth Circuit's ruling that a corporate insider can trade with impunity as long as he retains most of his stock conflicts with the black-letter rule that an insider or tippee in possession of material information must "disclose or abstain"

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[17] *See Poller v. CBS, Inc.*, 368 U.S. 464, 473 (1962) (summary judgment disfavored where intent is at issue). *Accord Schoenbaum v. Firstbrook*, 405 F.2d 215, 218 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

– *i.e.*, he must disclose what he knows or abstain from trading *altogether. See Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (insider trading liability premised on the sale of only 1,800 shares); *SEC v. Texas Gulf Sulphur Co., supra* (defendants liable for insider trading based on the sale of less than 15,000 shares by 12 defendants). Moreover, other courts of appeal have made clear that where an insider's stock sales are dramatically out of line with his prior trading practices at times calculated to maximize personal benefit from undisclosed inside information, an inference of *scienter* arises. *See, e.g., Lilly v. State Teachers Retirement System*, 608 F.2d 55, 56 (2d Cir. 1979), *cert. denied*, 446 U.S. 939 (1980) (sale of 80,000 shares nine days prior to public announcement that "problem loans" had increased from $7 million to $16 million). *See SEC v. Musella*, 748 F.Supp. 1028 (S.D.N.Y. 1989). No other circuit has held that an inside trader can "conclusively rebut" *scienter* merely by showing that he did not sell all or most of his stock.

Second, mere self-serving declarations cannot provide a defense to liability under the securities laws. *See Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 157-58 (1970) (self-serving denials of wrongdoing by interested parties do not control). Thus, the Second Circuit has held that an insider's "explanation" of his stock trades does not "conclusively rebut" *scienter* where there is other evidence from which a trier-of-fact could conclude that the trades were made with guilty knowledge of undisclosed material information. *Lilly*, 608 F.2d at 60-63; *Accord Pearl v. Geriatric & Med. Centers, Inc., supra* n. 16, at *6-*7.

Furthermore, the mere fact that the prospectus contained cautionary disclosures does not provide a defense to liability, especially where the disclosures are themselves misleading. *See Virginia Bankshares*, 115 L.Ed. 2d at 948-49.

Finally, the mere showing that the Officers remained on the job after the Offering and attempted to implement an ambitious manfacturing plan cannot "conclusively rebut" *scienter*. That evidence is not inconsistent with the Investors' showing that the Officers intentionally, knowingly or recklessly made false statemetns and engaged in insider trading.

No other court has held that management's continued investment in a company or its products can "conclusively rebut" clear evidence that they lied to the investing public.

Thus, the Ninth Circuit's rulings regarding the liability of corporate insiders for misrepresentations and insider trading are inconsistent with the rulings of other circuits and this Court's precedent. Unless reviewed by this Court, those rulings will create loopholes which will be improperly exploited by inside traders and other securities violators. Accordingly, review should be granted on this issue.

D. A Writ of *Certiorari* Should Be Granted Because the Legal Standards Applied by the Ninth Circuit in Conducting its *De Novo* Review of the Motions for Summary Judgment Violated Rule 56 and Deprived the Investors of their Constitutional Rights Under the Seventh Amendment

The Seventh Amendment to the Constitution guarantees the right to a jury trial in civil cases. In light of that constitutional protection, this Court has held that summary judgment is available under Rule 56 only where the case is so one-sided that there are no material issues to present to the jury. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986). Thus, in resolving a motion for summary judgment, all of the direct evidence submitted by the party opposing summary judgment is to be accepted as true, irrespective of the contrary evidence offered by the moving party; and the Court is constrained to draw all justifiable inferences from the evidence in favor of the nonmoving party. *Eastman Kodak Co. v. Image Technical Services, Inc.*, ___ U.S. ___, 112 S. Ct. 2072 (1992).

The Ninth Circuit disregarded these principles. Rather, in conducting its *de novo* review of the district court's summary judgment ruling, the court acted as a trier-of-fact, improperly weighing and resolving conflicts in the evidence. Thus, the Court held that Deloitte's evidence "negated" the Investors' showing on the issue of *scienter*, and that the Investors' evidence on the issue of WOW's liquidity was "not very probative." *WOW II*, 35 F.3d at 1416, 1426. Furthermore, both in determining whether triable issues existed regarding

whether or not the Prospectus was misleading, and in deciding the *scienter* issues with respect to the Officers, Directors and Venture Capitalists, the Ninth Circuit resolved all conflicts in the evidence in the defendants' favor and refused to make justifiable inferences in favor of the Investors. *See Section* V.C., at 27-29. Finally, the Ninth Circuit appears to have decided that Mr. Rossi, the Investors' accounting and auditing expert, was not a credible witness and, accordingly, refused to assign any weight to his opinion or any of the evidence discussed therein.

The Ninth Circuit conducted its Rule 56 analysis in a manner inconsistent with the standards dictated by this Court's precedents. In so doing, the Ninth Circuit violated the Investors' Seventh Amendment right to a jury trial. *Robertson v. White*, 635 F. Supp. 851, 870 (W.D. Ark. 1986). *See Mattison v. Dallas Carrier Corp.*, 947 F.2d 95, 108 (4th Cir. 1991) ("The right to jury trial secured by the Seventh Amendment . . . reserves the weighing of evidence and the finding of facts exclusively to the jury.") A writ of *certiorari* should be granted on this issue.

VI. CONCLUSION

For the foregoing reasons, the opinion below requires review by this Court. Accordingly, petitioners respectfully request this Court to issue a writ of *certiorari*.

Respectfully submitted,

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In re WORLDS OF WONDER SECURITIES LITIGATION.

Rosetta MILLER; Walter Untermeyer; Alan Nisselson; Trudy Whitman Nisselson; Paul Greenstein; Howard H. Weston, as Trustee for the Florida Municipal, Inc. Restated Defined Benefit Trust and Plan; Sylvia Wind, on behalf of themselves and the certified class of purchasers of securities of Worlds of Wonder, Inc., Plaintiffs-Appellants,

v.

Angelo M. PEZZANI; Donald D. Kingsborough; Richard B. Stein; John B. Howenstine; Barry H. Margolis; Deloitte & Touche; Smith Barney, Harris, Upham & Co.; Dean Witter Reynolds, Inc.; Josephine E. Abercrombie; Worlds of Wonder Shares Partnership; Robinson Interests, Inc., Defendants-Appellees.

Nos. 93-15321, 93-15535.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Aug. 10, 1994.

Decided Sept. 15, 1994.

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William F. Alderman, Orrick, Herrington & Sutcliffe, San Francisco, CA, for defendants-appellees Smith Barney and Dean Witter Reynolds.

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Layne E. Kruse, Fulbright & Jaworski, Houston, TX, and Marvin D. Morgenstein, Morgenstein & Jubelirer, San Francisco, CA, for defendant-appellee Robinson Interests, Inc.

Appeals from the United States District Court for the Northern District of California.

Before: FLETCHER, HALL, and WIGGINS, Circuit Judges.

CYNTHIA HOLCOMB HALL, Circuit Judge:

In this appeal, we consider the saga of Worlds of Wonder, Inc. ("WOW"), a toy company that sold $80 million of "junk bonds" to the investing public in June

1987. When WOW defaulted on its very first interest payment and filed for bankruptcy just six months later, rendering the securities worthless, a class of disappointed investors filed this securities-fraud action, naming as defendants WOW's officers, directors, auditors, underwriters, and major shareholders. The district court granted summary judgment in favor of all defendants and the investors appealed. After considering a myriad of issues, we affirm in part and reverse in part.

I.

In 1985, Donald Kingsborough formed WOW to manufacture and distribute "The World of Teddy Ruxpin," a product line featuring animated toy bears and accessories. Teddy Ruxpin was an immediate success, becoming a top seller for the 1985 Christmas season and generating net sales of $93 million in WOW's first fiscal year, which ended March 31, 1986. Shortly thereafter, WOW launched "Lazer Tag," a product line featuring infrared toy weapons. Lazer Tag became another instantaneous hit and, as Teddy Ruxpin continued to move briskly off the shelves, WOW posted two of the ten best-selling toys of the 1986 Christmas season. Ultimately, WOW recorded net sales of $327 million for fiscal 1987, which ended March 31, 1987.

Hoping to fund further expansion, WOW conducted a public offering of unsecured 9% convertible subordinated debentures on June 4, 1987 ("the Debenture Offering"), raising $80 million. (In common parlance, the debentures were "junk bonds" because they bore an above-market interest rate to compensate for the risk

associated with their "below investment grade" rating). This additional infusion of capital, however, proved inadequate to sustain the corporation's uncontrolled growth and, almost immediately, WOW commenced a series of public disclosures that led to sharp declines in the market price of the debentures and, eventually, to a total financial collapse.

On July 27, 1987, the corporation reported losses of $10 million for the first quarter of fiscal 1988, ending June 30, 1987. Shortly thereafter, on August 7, 1987, WOW terminated fifteen percent of its domestic workforce (fifty-five employees) and announced reductions in capital expenditures. Two months later, the corporation disclosed that it had laid off another seventeen percent of its workforce (sixty employees) and engaged in further cost-cutting measures. On November 9, 1987, WOW reported net losses of $43 million for the second quarter of fiscal 1988, ending September 30, 1987, and announced price reductions on Teddy Ruxpin and Lazer Tag. Finally, after 1987 Christmas sales fell far below projections, WOW defaulted on the first interest payment of the debentures and, shortly thereafter, filed for bankruptcy on December 21, 1987, rendering the securities worthless.

Several purchasers of WOW debentures ("the plaintiffs") subsequently filed this class action, alleging securities fraud in connection with the Debenture Offering, against (1) WOW officers Kingsborough, Angelo Pezzani, and Richard Stein ("the Officers"); (2) WOW directors John Howenstein and Barry Margolis ("the Directors"); (3) WOW's auditor Deloitte & Touche (formerly Deloitte Haskins & Sells) ("Deloitte"); (4) WOW's underwriter, Smith Barney, Harris Upham & Co. ("Smith Barney"); and

(5) WOW shareholders Josephine Abercrombie, Robinson Interests, Inc., and Worlds of Wonder Shares Partnership ("the Shareholders"). The plaintiffs claimed that the prospectus accompanying the offering ("the Debenture Prospectus") was false and misleading in violation of sections 11 and 12(2) of the Securities Act of 1933 ("1933 Act") and section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and that the Directors and Shareholders had engaged in insider trading in violation of section 10(b).

After a tortured five years of proceedings,[1] the district court granted summary judgment in favor of all defendants in an exhaustive opinion. *See In re Worlds of*

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[1] *See In re Worlds of Wonder Sec. Litig.*, 694 F.Supp. 1427 (N.D.Cal.1988) (dismissing plaintiffs' complaint without prejudice for failure to comply with Federal Rule of Civil Procedure 9(b)) *[WOW I]; In re Worlds of Wonder Sec. Litig.*, 721 F.Supp. 1140 (N.D.Cal.1989) (dismissing in part plaintiffs' amended complaint for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6)) *[WOW II]; In re Worlds of Wonder Sec. Litig.*, 1989-90 Fed.Sec.L.Rep. (CCH) ¶ 95,004, 1990 WL 61951 (N.D.Cal.1990) (certifying plaintiffs' class as those who purchased WOW securities between June 20, 1986 and November 9, 1987) *[WOW III]; In re Worlds of Wonder Sec.Litig.*, 1990 Fed.Sec.L.Rep. (CCH) ¶ 95,689, 1990 WL 260675 (N.D.Cal.1990) (denying Shareholders' initial motion for summary judgment on the insider trading claims) *[WOW IV]; In re Worlds of Wonder Sec. Litig.*, 1992 Fed.Sec.L.Rep. (CCH) ¶ 97,018, 1992 WL 330411 (N.D.Cal.1992) (granting plaintiffs' motion to quash defendants' subpoenas of absent class members) *[WOW V]; In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 208 (N.D.Cal.1992) (denying Officers' motion to quash plaintiffs' subpoena to Securities Exchange Commission for documents from an investigation of WOW) *[WOW VI]; In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 214 (N.D.Cal.1992) (denying plaintiffs' motion to compel Deloitte to produce internal audit manuals) *[WOW VII]*.

Wonder Sec. Litig., 814 F.Supp. 850 (N.D.Cal.1993) [WOW]. The court held that (1) with the possible exception of the audited 1987 financial statements, the Debenture Prospectus fully disclosed the risks of investing in WOW and that, as a result, under the "bespeaks caution" doctrine the document was not false or misleading as a matter of law; (2) even if the 1987 financial statements were false or misleading, all defendants had established affirmative defenses to section 11 liability; and (3) the plaintiffs had not established that any defendant acted with scienter sufficient to attach liability under section 10(b).

We conduct *de novo* review of the district court's grant of summary judgment. *E.g., Morris v. Newman (In re Convergent Technologies Sec. Litig.)*, 948 F.2d 507, 512 (9th Cir.1991). In so doing, we are mindful that, "[a]lthough materiality and scienter are both fact-specific issues which should ordinarily be left to the trier of fact, summary judgment may be granted in appropriate cases. Summary judgment may be defeated in a securities fraud derivative suit only by showing a genuine issue of fact with regard to a particular statement by the company or its insiders." *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 500 (9th Cir.1992) (citations and quotations omitted).

II.

We turn first to the plaintiffs' claims against the Officers, the Directors, Smith Barney, and Deloitte under section 11 of the 1933 Act, which creates a private right of action in favor of securities purchasers who rely upon a materially false or misleading prospectus. *See* 15 U.S.C.

§ 77k(a). The district court held that (1) except for possible errors in the certified 1987 financial statements that were appended to the document, "there are no statements in, or omissions from, the Debenture Prospectus that would give rise to an inference that any part of the document was false or misleading," *WOW*, 814 F.Supp. at 866, and (2) even assuming that the 1987 financial statements were false or misleading, each defendant had established an affirmative defense to section 11 liability as a matter of law.

A.

In concluding that the "textual part" of the Debenture Prospectus was not false or misleading, the district court analyzed the plaintiffs' claims of misrepresentation under the rubric of the "bespeaks caution" doctrine:

> . . . The doctrine holds that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved. It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based. . . .
>
> In the context of a summary judgment motion, . . . [t]he doctrine holds that where a prospectus contains adequate cautionary language disclosing specific risks, no reasonable

> inference can be drawn that a statement regarding those risks was misleading.

Id. at 858, 859 (footnote omitted).[2] The court also analyzed the plaintiffs' claims in the context of information about WOW known to the market at the time of the offering:

> . . . [T]he major rating agencies classified [WOW's] debentures as "junk bonds." That this fact was widely disseminated throughout the market is reflected by the 9% interest rate for the debentures, which was substantially higher than the market rate for lower risk securities.
>
> Since WOW was widely considered in the marketplace to be a risky investment, Plaintiffs'

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[2] Noting that, "[i]f the documents are completely silent on a matter, the 'bespeaks caution' doctrine is inapplicable [because] [o]ne cannot simultaneously bespeak caution on a subject and not address it," the district court applied the *Basic* test of materiality to the plaintiffs' claims that the Debenture Prospectus omitted material information: "[F]or nondisclosure to be actionable 'there must be a *substantial* likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly* altered the 'total mix' of information made available.' " *WOW*, 814 F.Supp. at 859 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32, 108 S.Ct. 978, 983-84, 99 L.Ed.2d 194 (1988) (emphasis added)).

The court subsequently paraphrased the Basic test in imprecise terms, indicating that the alleged omissions would be material only if "a reasonable investor would have felt the information *necessary* in deciding whether to invest in WOW." *Id.* at 859 (emphasis added). The plaintiffs claim this error (substituting "necessary" for "important") mandates reversal. We disagree. The plaintiffs point to no *application* of an incorrect materiality standard and, as a result, the court's misstatement was harmless.

> allegations that statements in or omissions from the Debenture Prospectus were misleading deserve especially careful scrutiny. . . .

Id. at 864.

On appeal, the plaintiffs contend that the district court erred by adopting and applying the bespeaks caution doctrine and by granting summary judgment despite evidence indicating that the textual part of the Debenture Prospectus contained material misstatements and omissions. We consider these contentions in order.

1.

"The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law (typically in a motion to dismiss for failure to state a cause of action or a motion for summary judgment) that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud." Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus.Law. 481, 482-83 (1994) [*Disclosures*]. At least six circuits have adopted some form of the doctrine. *See Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir.1994); *Kaufman v. Trump's Castle Funding (In re Donald J. Trump Casino Sec. Litig.)*, 7 F.3d 357, 371-73 (3d Cir.1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 1219, 127 L.Ed.2d 565 (1994); *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir.1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir.1991); *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir.1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir.1991).

Moreover, since the district court's opinion in this case, several trial courts in this circuit have also embraced the doctrine. *See In re Quarterdeck Office Sys., Inc. Sec. Litig.*, 854 F.Supp. 1466, 1471 (C.D.Cal.1994); *Forrester v. Microtest, Inc.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,072, 1993 WL 616688 (D.Ariz.1993); *In re Allergan Inc. Sec. Litig.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,066, 1993 WL 623321 (C.D.Cal.1993); *cf. Wade v. Industrial Funding Corp.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,144, 1993 WL 650837 (N.D.Cal.1993) (recognizing the doctrine but holding it inapplicable to the facts of the case); *Anderson v. Clow*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 97,807, 1993 WL 497212 (S.D.Cal.1993) (same).

Despite this wealth of authority, the plaintiffs breathlessly attempt to portray the bespeaks caution doctrine as a radical departure from settled law and as contrary to the letter and spirit of federal securities statutes. In reality, it is neither. Rather, the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance. The Fifth Circuit recently explained:

> The "bespeaks caution" doctrine . . . reflects a relatively recent, ongoing, and somewhat uncertain evolution in securities law, an evolution driven by the increase in and the unique nature of fraud actions based on predictive statements. In essence, predictive statements are just what the name implies: predictions. As such, any optimistic projections contained in such statements are necessarily contingent. Thus, the "bespeaks caution" doctrine has

> developed to address situations in which optimistic projections are coupled with cautionary language – in particular, relevant specific facts or assumptions – affecting the reasonableness of reliance on and the materiality of those projections. To put it another way, the "bespeaks caution" doctrine reflects the unremarkable proposition that statements must be analyzed in context.

Rubinstein, 20 F.3d at 167 (footnotes omitted). *Accord Trump Casino*, 7 F.3d at 364 ("[The doctrine] represents new nomenclature rather than substantive change in the law."); *see generally Disclosures*, 46 Bus.Law. at 487 (explaining materiality and reliance components of the doctrine).

In this light, the district court's measured application of the bespeaks caution doctrine was entirely consistent with the above-noted authority and established Ninth Circuit precedent. *See McGonigle v. Combs*, 968 F.2d 810, 817 (9th Cir.) (affirming summary judgment in favor of defendants where "no rational jury could find the comparative figures [in the prospectus] to have been material in light of their openly hypothetical nature and the specific disclaimers" in the document), *cert. dismissed*, ___ U.S. ___, 113 S.Ct. 399, 121 L.Ed.2d 325 (1992); *Convergent Technologies*, 948 F.2d at 515, 516 (holding that a prospectus was not materially misleading because it "virtually overflows with . . . repeated emphasis of significant risk factors"); *cf. Trump Casino*, 7 F.3d at 371 (interpreting *Convergent Technologies* as "applying but not explicitly referring to the bespeaks caution doctrine"); *Moorhead*, 949 F.2d at 246 (same).

In this case, the district court applied the doctrine narrowly:

> . . . [A]n overbroad application of the doctrine would encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language. To prevent this from occurring, the bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim.

WOW, 814 F.Supp. at 858 (citations and quotations omitted); *see Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 489 (3d Cir.1994) ("application of the 'bespeaks caution' doctrine . . . requires that the language bespeaking caution relate directly to that to which plaintiffs claim to have been misled"). As a result, notwithstanding the plaintiffs' shrill arguments to the contrary, the court's context-specific approach entirely comports with *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S.Ct. 2749, 115 L.Ed.2d 929 (1991), in which the Supreme Court noted that "[w]hile a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil. . . . [Therefore,] publishing accurate facts . . . can render a misleading proposition too unimportant to ground liability," *id.* at 1097, 111 S.Ct. at 2760-61; *see Rubinstein*, 20 F.3d at 167-68 & nn. 26-27; *Trump Casino*, 7 F.3d at 372-73 & nn. 14-16 ("we believe that our approach comports

with the Supreme Court's reasoning in *Virginia Bankshares*"); *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir.1993) ("*Virginia Bankshares* contemplates a weighing of the true with the untrue statements . . . for liability to result").

In our view, the bespeaks caution doctrine helps "to minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement." *Romani*, 929 F.2d at 878 (quotation omitted); *see generally Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740, 95 S.Ct. 1917, 1927-28, 44 L.Ed.2d 539 (1975) ("in the field of federal securities laws governing disclosure of information[,] even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as [the plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment"). Therefore, because it is consistent both with precedent from this circuit and with well-settled principles of securities law articulated by courts across the country, we adopt the district court's formulation of the doctrine.[3]

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[3] The plaintiffs appear to contend that, if the bespeaks caution doctrine is viable, it applies only to section 10(b) claims and not to section 11 claims. This argument is plainly wrong. As noted, the doctrine is primarily an application of the materiality concept, which applies equally to both statutory provisions. *E.g., Halkin v. VeriFone Inc. (In re VeriFone Sec. Litig.)*, 11 F.3d 865, 868-69 (9th Cir.1993). Accordingly, courts have applied the doctrine to section 11 claims as well as section 10(b) claims. *See, e.g., Trump*, 7 F.3d at 365; *I. Meyer Pincus*, 936 F.2d at 761; *see generally Disclosures*, 49 Bus.Law. at 483.

2.

Turning to the merits, the plaintiffs claim the textual disclosures in the Debenture Prospectus were false or misleading in four general areas: liquidity, internal controls, revenue recognition, and sales performance. We consider each in order.

a.

The plaintiffs first contend that the prospectus was false and misleading because it stated that WOW expected to have sufficient cash to operate through March 31, 1988. The prospectus made the following disclosures regarding liquidity:

> *Seasonality of Quarterly Results*. . . . There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in seasonal demand. . . .
>
> *Capital Requirements*. . . . To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts. . . . The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities presently being negotiated, will provide sufficient funds to meet the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on

> acceptable terms, its operations would be adversely affected. . . .
>
> *Liquidity and Capital Resources.* Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support growth. . . .
>
> To meet seasonal working capital requirements, management expects to continue to borrow substantial amounts under its bank line of credit and its import financing line, both of which it expects to replace or extend prior to expiration. Based on its current plan of operations, management anticipates that existing credit facilities and new bank facilities presently being negotiated, together with the proceeds of the offering of the Debentures and funds from operations, will be sufficient to meet the Company's short-term cash requirements through March 31, 1988.

After reviewing the document, the district court concluded that the prospectus "clearly bespoke caution on the serious risks WOW's liquidity crisis posed to investors. . . . Plaintiffs are not entitled to an inference that they were misled in the face of such disclosures." *WOW*, 814 F.Supp. at 866. We agree.

The plaintiffs argue that the prospectus was misleading because a reduction in size of the Debenture Offering (from $100 million to $80 million) rendered the proceeds inadequate and because WOW was so desperate for cash that the corporation became insolvent a mere sixteen days after the offering closed. Neither contention is supported by the evidence. Regarding the reduction in size, the plaintiffs presented no evidence that, at the time of

the offering, it was foreseeable that $80 million would be insufficient to enable WOW's continued operations. The defendants, on the other hand, introduced evidence indicating that the reduced amount was sufficient to meet all projected capital needs. In fact, Smith Barney specifically analyzed WOW's capital requirements based on an assumption of a $75 million offering and found that lower figure to be sufficient.

Similarly, no evidence supports the plaintiffs' claim that WOW "ran out of cash" immediately after the offering. The plaintiffs cite a memorandum by WOW's lender, First National Bank of Chicago ("First Chicago"), indicating that the corporation had exhausted its credit line shortly after the offering. That memorandum, however, does not prove what the plaintiffs suggest. It was known that WOW would need to continue to borrow after the infusion of capital. The Debenture Prospectus specifically disclosed that the corporation would continue to draw on the credit line, and in fact, several months after the offering and after conducting its own independent investigation, First Chicago renewed the line. Had WOW been insolvent, one would not expect the bank to have extended further credit. The plaintiffs make much of another allegedly damaging memorandum in which a WOW officer speculated that the corporation might suffer significant cash shortfalls in late 1987. That document, however, is not very probative because the officer wrote it *after* the Debenture Offering, apparently for the sole purposes of detailing scenarios for "contingency planning."

Given the plaintiffs' lack of probative evidence and the Debenture Prospectus' specific references to WOW's

continuing cash shortfall and borrowing requirements, the district court was correct to conclude that the prediction of liquidity was not materially misleading as a matter of law. *See Trump Casino*, 7 F.3d at 369 ("The prospectus at issue contained an abundance of warnings and cautionary language which bore directly on the prospective financial success of the [casino] and on the [venture]'s ability to repay the bonds. . . . [D]ue to the disclaimers and warnings . . . , no reasonable investor could believe anything but that the [casino] represented a rather risky, speculative investment which might yield a high rate of return, but which might alternatively result in no return or even a loss."); *Moorhead*, 949 F.2d at 245-46 & n. 2 (no material misrepresentation by projecting that a proposed venture would generate sufficient revenue to service offered bonds where there were "repeated, specific warnings of significant risk factors"). We therefore affirm the summary judgment on this issue.

b.

The plaintiffs next argue that the following Debenture Prospectus description of WOW's internal controls was materially misleading:

> *Information Systems and Control Procedures.* The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures

> and controls to meet the demand of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with the growth.

The plaintiffs contend that, in fact, WOW's internal controls at the time of the offering had "crippling deficiencies" and that "no reasonable investor reading the Prospectus would have concluded that there were any *existing* problems with controls." The district court disagreed: "Plaintiffs ignore the fact that the Prospectus included an express disclaimer that 'there can be no assurances' that WOW's existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke caution regarding this potential risk to WOW's investors. As a matter of law, Plaintiffs cannot have been misled." *WOW*, 814 F.Supp. at 865. This conclusion is correct for several reasons. First, contrary to the plaintiffs' assertions, the Debenture Prospectus did not state or imply that WOW's internal control problems were "in the past" and not ongoing. Rather, the prospectus clearly warned that the company's attempt to improve internal controls could prove to be inadequate. Second, the plaintiffs presented no evidence that WOW's internal controls at the time of the offering were materially deficient. Indeed, the allegedly "devastating" management letter issued by Deloitte (two-and-a-half months *after* the Debenture Offering) concluded that, although "significant problems" existed, WOW's internal controls had no material weaknesses. And, third, WOW probably would not have needed to disclose even serious internal-control

deficiencies. *Cf. Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir.1994) (holding that an auditor need not disclose internal controls).

The Debenture Prospectus, which noted that WOW had struggled to maintain sufficient internal controls, clearly erred on the side of *over* disclosure and was therefore not misleading. We affirm the district court on this point.

c.

The plaintiffs next argue that the Debenture Prospectus was misleading because it failed to disclose that WOW engaged in various tactics to "pump up" revenue figures without completing actual sales. Specifically, the plaintiffs contend the prospectus misleadingly omitted WOW's observance of "price protection" (the right to reimbursement in the event of post-sale price reductions), "stock balancing" (the post-sale right to exchange non-defective products for different merchandise), and "guaranteed sales" (the unqualified right to return non-defective products).

The argument regarding price protection and stock balancing is without merit for several reasons. First, the plaintiffs introduced "no evidence that, at the time of the Debenture offering, WOW's management could have foreseen that WOW would have to reduce prices to [the extent it actually did so in late 1987]. Thus, the alleged practice of price protection did not pose a foreseeable risk to WOW's investors at the time of the Debenture offering, so WOW had no duty to disclose it." *WOW*, 814 F.Supp. at 865. The speculative impact of future exchanges and price

reductions was not material. *See Hanon*, 976 F.2d at 506 ("potential action to be taken sometime in the distant future is not an item appropriately made a part of a public disclosure because of its speculativeness"). And, second, the plaintiffs concede that price protection is a common practice in the toy industry. The undisputed evidence also indicates that stock balancing is commonplace in the industry. As a result, WOW had no duty to disclose its observance of those practices. *See Hanon*, 976 F.2d at 505 (no duty to disclose a "known condition"); *Convergent Technologies*, 948 F.2d at 513 (no duty to disclose a risk "the market clearly understood"); *Schneider v. Vennard (In re Apple Computer Sec. Litig.)*, 886 F.2d 1109, 1119 (9th Cir.1989) (no duty to disclose the fact that buyers could cancel orders at will because "it was well understood within the investment community that computer orders are 'soft' "), *cert. denied*, 496 U.S. 943, 110 S.Ct. 3229, 110 L.Ed.2d 676 (1990); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir.1980) ("[i]t is not a violation of any securities laws to fail to disclose a result that is obvious").

Although a slightly closer call, the plaintiffs' contention regarding guaranteed sales fares no better. We agree that a company that "substantially overstate[s] its revenues by reporting consignment transactions as sales . . . mak[es] false or misleading statements of material fact." *Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir.1994). And we acknowledge that the plaintiffs did present some evidence that WOW engaged in guaranteed sales prior to the Debenture Offering, particularly in the final quarter of fiscal 1987.

The evidence indicates, however, that Deloitte analyzed WOW's sales practices and concluded that, "[w]hile it is true that on a few occasions prior to the 1987 audit, WOW made the business decision to permit customers to return or exchange nondefective products, these returns were minimal in number, and did not have a material impact on WOW's financial statements taken as a whole." As the district court noted, "[j]ust because some of WOW's customers were allowed a refund does not mean that . . . WOW had a practice of offering guaranteed sales to all its customers. Giving an unsatisfied customer a refund is a normal business method of dealing with an unsatisfied customer. It is not a violation of securities laws for WOW to fail to disclose such an obvious practice to potential investors." *WOW*, 814 F.Supp. at 862.

The plaintiffs' evidence of guaranteed sales is speculative, nebulous, and nowhere purports to quantify the degree to which WOW engaged in this "normal business" practice. As such, it does not rise to the level of a material omission. *Cf. Malone*, 26 F.3d at 478 (expert testimony specifically indicated that the company's undisclosed consignment sales accounted for thirteen percent of total revenue and made financial statements "not only misleading, but misleading in a material way"). The plaintiffs cannot defeat summary judgment merely by accusing WOW of trying to post favorable financial figures. *See Convergent Technologies*, 948 F.2d at 515 ("[P]laintiffs do not explain why [the issuer] would want to exclude such [one-time] sales. Plaintiffs suggest [the issuer] made the sales in the fourth quarter to post better numbers on its year-end financials and thus further its scheme to inflate

its stock price. Plaintiffs provide no evidence to support this suggestion."); *Vaughn*, 628 F.2d at 1221 ("Corporate officials are under no duty to disclose their precise motive or purpose for engaging in a particular course of action, so long as the motive is not manipulative or deceptive").

We therefore conclude the district court correctly held that the Debenture Prospectus was not misleading on this issue.

d.

Finally, the plaintiffs argue that the following Debenture Prospectus disclosures misstated WOW's performance in the first quarter of fiscal 1988 and generally hid the fact that, at the time of the Debenture Offering, sales of and demand for WOW products had declined precipitously:

> *Seasonality of Quarterly Results.* . . . The Company anticipates that net sales for the quarter ending June 30, 1987 will be less than those for each of the prior three quarters, and the Company expects to report a loss for the quarter. . . .
>
> *Net Sales.* . . . Because sales of toys are highly seasonal, the Company would generally expect net sales to be lower in the first half of the calendar year. The Company's net sales in the first quarter of fiscal 1987 were lower than net sales in each of the preceding two quarters. Similarly, the Company expects net sales for the first quarter of fiscal 1988 to be lower than sales for each of the prior three quarters. At the same

> time, the Company is continuing to expand its operations in anticipation of the Christmas selling season. As a result, the Company expects to report a net loss for the first quarter of fiscal 1988 proportionally greater than the net loss reported for the first quarter of fiscal 1987.

The plaintiffs contend the prospectus was misleading because it did not state that (1) WOW's performance in the first quarter (which ended a month *after* the Debenture Offering) would be "substantially" lower than the first quarter of the preceding year or (2) WOW's net quarterly loss would be "disproportionally greater" than that of the prior year. We reject this argument for several reasons.

First, as Smith Barney explains, "[t]he only reasonable reading [of the prospectus] is that, in light of the *lower* first quarter sales and the *higher* first quarter operating expenses the company was then expecting, WOW's net loss . . . was expected to constitute a 'greater proportion' of net revenue than . . . during the first quarter of 1987." The prospectus did not imply that WOW's first quarter 1988 losses would be proportional to its first quarter 1987 losses.

Second, the prospectus clearly warned that WOW expected lower net sales. WOW was under no duty to disclose the precise extent of the anticipated revenue drop. *See Backman v. Polaroid Corp.*, 910 F.2d 10, 16 (1st Cir.1990) (en banc) ("Disclosing that [a product] was being sold below cost was not misleading by reason of not disclosing how much below."). The plaintiffs complain that the prospectus failed to disclose the extent to which first quarter sales lagged behind WOW's internal

projections. The quarter, however, was not yet complete; had WOW actually disclosed its internal business plan, the plaintiffs probably would now be contending that no basis existed for such a prediction. *Cf. Convergent Technologies*, 948 F.2d at 516 ("It is just good general business practice to make . . . projections for internal corporate use. There is no evidence, however, that the estimates were made with such reasonable certainty even to *allow* them to be disclosed to the public.") (quotation omitted).

The plaintiffs also argue that the Debenture Prospectus violated section 11 by failing generally to reveal "WOW's crisis of sales and demand." The district court disagreed: "Plaintiffs submit no admissible evidence to show that WOW's sales had decreased so dramatically at the time of the Debenture offering that WOW's management could have known about, and thus would have had a duty to disclose, the impending collapse of Lazer Tag sales. Plaintiffs cannot use the benefit of 20-20 hindsight to turn management's business judgment into securities fraud." *WOW*, 814 F.Supp. at 865. We agree.

The plaintiffs argue that WOW's sales, for Lazer Tag in particular, began a dramatic collapse in January 1987 and that, because revenues prior to the Debenture Offering fell below WOW's internal business plan, WOW was required to disclose that "fact" in the Debenture Prospectus. The prospectus, however, fully disclosed WOW's sales for each of the eight completed fiscal quarters of its existence (through March 31, 1987). This disclosure revealed a significant decline in both net sales and net income for the first three months of 1987. The plaintiffs' complaint that WOW should have disclosed the ramifications of that drop in sales (*i.e.*, that the decline was due to

more than "normal seasonality") is without merit. *See Convergent Technologies*, 948 F.2d at 513 ("The challenged statements do not imply any comparison between the rate of past and future growth. They simply report past performance and assert specific limited predictions for the future."); *see generally Trump Casino*, 7 F.3d at 375 ("The federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably.").

Perhaps realizing this, the plaintiffs concentrate their argument on the not-completed first quarter of fiscal 1988. As noted above, the Debenture Prospectus disclosed that WOW would suffer a net loss in that quarter. Nevertheless, the plaintiffs argue that the corporation should have informed investors that demand for its products was, in fact, "dead." The evidence, however, indicates that all interested parties (including the Officers, Smith Barney, and WOW's retailers) anticipated that WOW's products would again sell well in fiscal 1988. Although first quarter sales were disappointing, the parties reasonably discounted WOW's performance in the first two months of that quarter as being relatively inconsequential. Indeed, WOW projected those two months to account for only four percent of its revenue for the year.

Just four days prior to the Debenture Offering, WOW commenced a production schedule implementing the corporation's optimistic business plan, which projected $542 million in sales. As the Officers note, if demand actually had dried up, the "[p]laintiffs cannot explain why WOW's entire senior and middle management would have lied to themselves about the Company's business outlook." *See Apple Computer*, 886 F.2d at 1117 ("[the

corporation]'s massive investment in [a new product] demonstrates this good faith" belief that it will succeed). The plaintiffs presented no admissible evidence to the contrary.[4] In sum, their argument distills to a contention that WOW should have predicted the collapse in sales that occurred in late 1987, long after the Debenture Offering. The corporation had no duty to do so. *See VeriFone*, 11 F.3d at 869 ("These alleged nondisclosures are, in substance, failures to make a forecast of future events. Put another way, what the complaint states is that [the issuer] omitted to state the 'fact' that future prospects were not as bright as past performance. Absent allegations that [the issuer] withheld financial data or other existing facts from which forecasts are typically derived, the alleged omissions are not of material, actual facts.

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[4] The plaintiffs did submit the declaration of John Forsythe, a former WOW collections manager, who stated that "I understood that it was common knowledge among the WOW sales personnel . . . that demand for products in the Lazer Tag line had collapsed" and that "I understood on the basis of my conversations with WOW sales personnel . . . that the 'pipelines were stuffed' with Lazer Tag kits." The district court, however, excluded this evidence because "Forsythe had no responsibility for WOW's sales, so he has no personal knowledge of this fact and could not testify to it at trial. If he were to testify to the fact that various retailers told him sales were poor, it would be inadmissable hearsay." WOW, 814 F.Supp. at 865 n. 12.

This ruling was not an abuse of discretion. *See McGonigle*, 968 F.2d at 818 n. 6 ("Evidentiary rulings are not reversible absent clear abuse of discretion."); *In re Convergent Technologies Second Half 1984 Sec. Litig.*, No. C-85-20130-SW, 1988 WL 215412 (N.D.Cal. Jan. 10, 1990) (excluding as hearsay the declaration of a company's former collections officer regarding "false sales . . . to inflate the stock price"), *aff'd mem.*, 942 F.2d 791 (9th Cir.1991).

Therefore, the forecasts need not have been disclosed, and the failure to make the omitted forecasts did not render the other statements that were made misleading."). We affirm the district court on this point.

e.

The avalanche of documents presented by the plaintiffs does little more than illustrate the fact that, at the time of the Debenture Offering, WOW's future was uncertain. The Debenture Prospectus adequately disclosed this fact and the market, which characterized the debentures as "junk bonds," realized it. As a result, we agree with the district court's summary of the plaintiffs' section 11 case:

> When a company fails, it does not automatically mean that a violation of the securities laws has occurred. There are a number of risks involved whenever one invests in any company. . . . The securities laws do not insulate investors against stock downturns which are caused by events not foreseeable to the company's management, nor do they provide insurance against risks that were disclosed to investors at the time they purchased the securities.
>
> In this case, WOW's investors took a gamble, as do all investors. They lost. Holders of shares and Debentures knew that WOW was not a diversified company. Its success was based on only two major products. . . . And, WOW's precarious cash position was not concealed from these investors. . . . It was obvious to any reasonable investor that if either of WOW's two

> products were to lose favor with consumers, the company would be devastated. . . .
>
> Plaintiffs have submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. [That is not sufficient].

WOW, 814 F.Supp. at 873. We affirm the district court's summary judgment in favor of the defendants regarding the textual part of the Debenture Prospectus.

B.

As noted above, the district court recognized that the "[p]laintiffs allege numerous errors in the financial statements for 1987, included in the back pages of the Debenture Prospectus," *WOW*, 814 F.Supp. at 864 (footnote omitted), and, as a result, decided to "conserv[e] judicial resources by assuming *arguendo* that the statements are in error, because summary judgment for defendants is clearly appropriate on other grounds," *id.* at 867 n. 13. We conclude that the "other grounds" on which the district court relied were sufficient to support summary judgment for all defendants except Deloitte.

1.

Because the audited 1987 financial statements were "certified" by Deloitte within the meaning of section 11,

every defendant other than the auditor can escape section 11 liability for the statements by establishing that they "had no reasonable ground to believe and did not believe . . . that the ["expertised"] statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(b)(3)(C). *E.g., In re Software Toolworks, Inc. Sec. Litig.*, 789 F.Supp. 1489, 1498 (N.D.Cal.1992), *appeal dismissed*, 16 F.3d 1073 (9th Cir.1994). The district court held that all defendants had proven this "reliance" defense:

> . . . [T]he issues are enormously complex on the question of whether Deloitte's recognition of revenues was in accordance with the standards of the accounting profession. The parties have generated well over 100 pages of conflicting expert testimony on these issues alone. It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistake by Deloitte. Therefore, even if there are errors in the financial statements, no defendant except Deloitte can be liable under section 11 on that basis.

WOW, 814 F.Supp. at 863-64. We agree.

The plaintiffs contend that the Officers, the Directors, and Smith Barney cannot invoke section 11's reliance defense because they "not only knew of the transactions which caused WOW's audited financial statements to be [allegedly] false and misleading, but actively structured and participated in those transactions." This argument entirely misses the point of the district court's ruling.

As the court recognized, "[p]laintiffs have admitted that WOW's management made full disclosure to Deloitte of all relevant information regarding the questioned transactions." *WOW*, 814 F.Supp. at 864. After disclosing the nature of the transactions, the defendants relied on Deloitte's *accounting decisions* (to permit revenue recognition) about the sales. Those expert decisions, which underlie the plaintiffs' attack on the financial statements, represent precisely the type of "certified" information on which section 11 permits non-experts to rely. *See Software Toolworks*, 789 F.Supp. at 1498 ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise.").

We therefore affirm the district court's conclusion that all defendants except Deloitte were immunized from section 11 liability for errors in the 1987 financial statements.

2.

Regarding Deloitte, the district court concluded that the auditor had established a "loss causation" defense:

> Damages for a Section 11 violation are measured by the difference between the amount paid for the security and its price at either the time it was sold or the date the Section 11 claim was filed. *See* 15 U.S.C. § 77k(e). Section 11(e), however, provides that:
>
> > [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value . . . resulting from such part of the registration statement[ ]

> with respect to which his liability is being asserted, . . . such portion or all of such damages shall not be recoverable.

Id. The defendant has the burden of proof on this defense. *Id.* Though it has been recognized by courts as a "heavy burden," it is not insurmountable, and courts have awarded summary judgment to the defendant in appropriate cases. *See In re Fortune Sys. Sec. Litig.*, 680 F.Supp. 1360, 1364-65 (N.D.Cal.1987).

This is such a case. It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debenture's decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. Since the marketplace never knew of any alleged accounting errors, the alleged errors cannot be said to have had any effect on the Debentures' market value.

WOW, 814 F.Supp. at 866-67. Because this analysis is based upon the faulty premise that Deloitte's alleged errors needed to be disclosed to the market before section 11 liability could attach, we reverse the summary judgment on this issue.

To establish a "loss causation" defense under section 11(e), Deloitte needed to prove "that the depreciation in value [of the debentures] resulted from factors other than the [alleged] material misstatement in the [1987 financial]

statement." *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d Cir.1987). *Accord, e.g., Fortune Sys.*, 680 F.Supp. at 1364. The district court concluded that Deloitte met this burden by showing that WOW never disclosed to the market the fact that the 1987 financial statements contained material errors. This analysis was, quite simply, far too narrow.

Loss causation exists where "the misrepresentation *touches upon* the *reasons* for the investment's decline in value." *McGonigle*, 968 F.2d at 821 (emphasis added) (quotation omitted) (section 10(b) case). *Accord, e.g., Fortune Sys.*, 680 F.Supp. at 1365 (section 11 case); *see generally Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461, 1468 (9th Cir.1990) ("what securities lawyers call 'loss causation' *is* the standard common law fraud rule" of "proximate causation") (quotation omitted) (section 10(b) case), *rev'd on other grounds*, ___ U.S. ___, 112 S.Ct. 1311, 117 L.Ed.2d 532 (1992); *cf. Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1332 (8th Cir.1991) ("all the Class needed to show [to establish 'loss causation'] was that the [issuer]'s bankruptcy was somehow *'related' to* Arthur Young's nondisclosure") (emphasis added) (section 10(b) case), *aff'd*, ___ U.S. ___, 113 S.Ct. 1163, 122 L.Ed.2d 525 (1993). The district court's application of section 11(e) ignores the broad nature of the "loss causation" determination. Indeed, the plaintiffs rightly note that, if correct, "[t]he district court's interpretation would eviscerate the statute. Companies and their auditors could immunize themselves from § 11 liability for false and even fraudulent financial statements simply by refusing to admit their falsity (or refusing to include in their adverse public disclosures information that would 'clue in the

market' to their falsity) prior to the time a § 11 suit is filed."

Under the correct inquiry, summary judgment was clearly inappropriate in this case. As Deloitte acknowledges, "the decline in the value of WOW's investment securities . . . corresponded precisely to a series of fiscal 1988 public disclosures." The plaintiffs introduced expert testimony that those disclosures *directly related* to the transactions for which Deloitte allegedly made erroneous accounting determinations, and that, as a result, Deloitte's alleged errors "touched upon" the reasons for the decline in the value of WOW's debentures. Several examples are illustrative:

> *The plaintiffs allege that Deloitte improperly recognized revenue on 1987 "sales" for which WOW offered price protection. WOW's subsequently announced losses for the second quarter of fiscal 1988 included a $13.2 million reserve for price protection in connection with the 1987 transactions. Following disclosure of those losses, the market price of the debentures declined.
>
> *The plaintiffs allege that Deloitte improperly recognized revenue on the 1987 "K-Mart Transaction," in which WOW offered the retailer extended payment terms, stock balancing, and guaranteed sales. When WOW subsequently announced losses for the second quarter of fiscal 1988, including a $9.9 million charge for K-Mart's cancellation of the "sales," the market price of the debentures declined.
>
> *The plaintiffs allege that Deloitte improperly failed to account for WOW's excess and obsolete inventory. When WOW subsequently

> announced losses for the second quarter of fiscal 1988, including the creation of a $12 million inventory reserve, the market price of the debentures declined.[5]

In light of that evidence, the auditor clearly did not overcome, as matter of law, "Congress' desire to allocate to the defendants the risk of uncertainty in [section 11(e)] cases." *Akerman*, 810 F.2d at 341.[6] We therefore reverse the

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[5] The district court said that it "failed to see the logic in plaintiffs' argument [on the loss causation issue]. The amount of revenue posted by a company during a prior year is a number that exists only on paper to reflect total sales during that year. The amount of actual cash the company has access to at the moment is not necessarily related to its total sales in the previous year. . . . The market [therefore] would not interpret WOW's running out of cash as a signal that its revenues for the previous year were overstated." *WOW*, 814 F.Supp. at 877.

Although undoubtedly true, the court's observations are wholly inapposite to the plaintiffs' argument. The plaintiffs contend that Deloitte's alleged errors directly affected the market price of the debentures by causing the creation of reserves to account for "false sales" and, in some cases, actually enabling WOW to consummate transactions it otherwise never would have attempted. That contention states a direct correlation between the alleged misstatements (faulty revenue recognition) and the loss (the decline in debenture price) and, accordingly, is sufficient to nullify Deloitte's "loss causation" defense on summary judgment.

[6] The plaintiffs also introduced evidence that Deloitte's alleged misrepresentations artificially inflated the offering price of the debentures. "Properly applied, the concept of loss causation will permit the plaintiff to recover only that damage caused by the misrepresentation: the amount paid over the true value." *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F.Supp. 1346, 1354 (W.D.Wash.1986). *See McGonigle*, 968 F.2d at 821 (loss causation exists where "the alleged omissions adversely

district court's holding that Deloitte established a "loss causation" defense as a matter of law and remand for a trial on the merits of (1) whether the 1987 financial statements were in fact misleading (an issue not decided by the court) and (2) whether Deloitte can affirmatively establish a loss causation defense.

III.

The plaintiffs asserted claims against Smith Barney under section 12(2) of the 1933 Act, which imposes additional liability on parties who sell securities with a false or misleading prospectus. *See* 15 U.S.C. § 771(2). The district court concluded that the plaintiffs' claims were meritless:

> The analysis this court applied to Plaintiffs' Section 11 claims . . . applies equally to Plaintiffs' claims under Section 12(2). This court

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affected the objective value of the[ ] investment"); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir.1987) (plaintiff may recover "the difference between the purchase price and the value of the stock at the date of purchase") (quotation omitted). Deloitte argued that this "artificial inflation" analysis, which has arisen in section 10(b) cases, is inconsistent with section 11(e), and the district court agreed. *See WOW*, 814 F.Supp. at 875-77.

Although we do not decide this issue because a remand is appropriate for other reasons, we do note that section 11(e) specifically provides that loss causation exists where a "depreciation in value" "result[s]" from a misleading statement in a prospectus. Although no court has considered section 11 loss causation in the manner urged by the plaintiffs, neither Deloitte nor the district court cited any authority purporting to disregard the plain statutory language in such a case.

> repeats its holding that there are no material omissions from the prospectus, aside from possible errors in the 1987 financial statements. . . .
>
> Regarding the alleged errors in the 1987 financial statements, . . . Smith Barney specifically sought and received assurances from Deloitte on the facts that supported Deloitte's decision to recognize revenue on the questioned transactions. Thus, Smith Barney clearly exercised reasonable care, and it did not have reason to know that there were any errors in the financial statements.

WOW, 814 F.Supp. at 867-68. We agree.

As noted above, the textual part of the Debenture Prospectus contains no material misstatements or omissions. Accordingly, Smith Barney has no section 12(2) liability for those disclosures.

Regarding the 1987 financial statements, we conclude that the plaintiffs waived their right to appeal the district court's determination that Smith Barney established a "due diligence" defense. In their eighty-page opening brief, the plaintiffs' only reference to section 12(2) was in a footnote, alleging that "[a]ll arguments asserted herein with respect to the § 11 claim against Smith Barney are applicable to the § 12(2) . . . claims against this defendant." Nowhere in their brief, however, did the plaintiffs discuss "due diligence." Indeed, even in their reply brief, the plaintiffs only mentioned due diligence with regard to the "textual parts of the Prospectus" and *not* with regard to the 1987 financial statements. This lack of argument waives an appeal of the issue. *E.g., Officers For Justice v. Civil Serv. Comm'n*, 979 F.2d 721, 726 (9th

Cir.1992) ("We will not ordinarily consider matters on appeal that are not specifically and distinctly raised and argued in appellant's opening brief.") (quotation omitted), *cert. denied*, ___ U.S. ___, 113 S.Ct. 1645, 123 L.Ed.2d 267 (1993).

We therefore affirm the district court's summary judgment in favor of Smith Barney on the section 12(2) claim.

IV.

Finally, the plaintiffs asserted claims against all defendants under section 10(b) and Rule 10b-5 of the 1934 Act, which provide liability for deceptive conduct in connection with the sale of securities. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. To establish section 10(b) liability, the plaintiffs must show that the defendants acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n. 12, 96 S.Ct. 1375, 1381 n. 12, 47 L.Ed.2d 668 (1976); *see Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir.1990) (en banc) (holding that recklessness constitutes scienter under section 10(b)), *cert. denied*, 499 U.S. 976, 111 S.Ct. 1621, 113 L.Ed.2d 719 (1991).

A.

The district court held that the plaintiffs had no section 10(b) claims based on the textual part of the prospectus because, "as a matter of law, there are no misleading statements in, or material omissions from, the

Debenture Prospectus, aside from possible errors by Deloitte in the 1987 financial statements." *WOW*, 814 F.Supp. at 869. Because the standard of materiality is the same under section 10(b) as it is under section 11, *e.g.*, *VeriFone*, 11 F.3d at 868-69, we affirm this conclusion for the reasons stated above.

B.

The plaintiffs, however, also asserted section 10(b) claims based "on alleged fraudulent conduct by [some] defendants other than the [textual part of the] prospectuses." *WOW*, 814 F.Supp. at 869. The district court held that summary judgment was appropriate for all defendants on these claims because the plaintiffs could not establish scienter.

1.

With regard to the Officers, the court concluded as follows:

> . . . Plaintiffs allege in conclusory fashion that the Officer Defendants violated Rule 10b-5 by misleading "press releases, filings with the SEC, statements to analysts, etc." The Officers Defendants[']overall pattern of conduct, though, rebuts any inference of knowing or reckless conduct on their part. If WOW's officers were bent on committing fraud, it is not likely that they would have provided such detailed risk disclosure in the prospectuses. Furthermore, if, as Plaintiffs allege, the Officers knew that WOW was heading for financial disaster, they probably would have bailed out of their

> substantial holdings. Each of the Officer Defendants, by contrast, held onto most of their WOW stock and incurred the same large losses as did the Plaintiffs themselves. . . .

Id. at 869. We agree.

The plaintiffs produced no direct evidence of any scienter on the part of the Officers. Rather, the plaintiffs seek to rely on speculative inferences that arise from the Officers' allegedly suspicious conduct. The Officers, however, conclusively rebutted any such inference that might have been permissible. *See generally DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.) ("The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. . . . Because only a fraction of financial deteriorations reflects fraud, [however,] plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud."), *cert. denied*, 498 U.S. 941, 111 S.Ct. 347, 112 L.Ed.2d 312 (1990).

The detailed risk disclosure in the Debenture Prospectus negates an inference of scienter. *E.g., Ferber v. Travelers Corp.*, 802 F.Supp. 698, 714 (D.Conn.1992) ("defendants' provision of adverse information to the public by way of disclosures negates an inference that they acted with an inten[t] to defraud") (quotation omitted); *see also DiLeo*, 901 F.2d at 629 ("People sometimes act irrationally, but indulging inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another

has behaved irrationally has to make a strong case."). Similarly, the Officers' minimal sales of stock also negates an inference of scienter. *See Apple Computer*, 886 F.2d at 1117 ("credible and wholly innocent explanations for the stock sales . . . are sufficient to defeat any inference of bad faith").

Moreover, the Officers' post-offering efforts to continue WOW's expansion, including increased expenditures on advertising and product development, evince their good faith belief in WOW's prospects for success. *See id.* at 1118 ("Any remote inference of bad faith arising from the defendants' stock sales is completely dispelled by the defendants' overall pattern of conduct. Throughout the class period, the defendants continued to stake much of [the corporation]'s future on the success [of a new product], pouring millions of dollars into product development, market research, and promotions. At the same time, defendants retained the great bulk of their holdings, and held on in the face of a decline of almost 75% following disclosure of [the product]'s disappointing sales. . . . We cannot conclude that this conduct is so inconsistent with the defendants' expressed optimism as to raise a triable issue regarding the defendants' good faith.").

We affirm the district court's conclusion that the plaintiffs had not established scienter on the part of the Officers.

2.

Consistent with its section 11 analysis, the district court recognized that issues of fact existed as to whether

Deloitte was liable for material misstatements or omissions in the 1987 financial statements. The court held, however, that summary judgment was appropriate because Deloitte had not acted with scienter:

> Deloitte has submitted evidence showing that it extensively investigated, carefully addressed, reasonably resolved, and thoroughly documented every transaction where Plaintiffs allege revenue was improperly recognized. Also, Deloitte submits the declarations of its accountants that recognition of the revenue was proper in accordance with Generally Accepted Accounting Principles ("GAAP"). . . .
>
> Plaintiffs respond . . . with the declaration of [alleged expert] Albert Rossi. . . . Rossi's testimony, in substance, is that for everything Deloitte's accountants did, he would have done more, and that in his opinion, the revenues were improperly recognized under GAAP. Rossi concludes that "[t]he danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it."
>
> As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. *Apple Computer*, 886 F.2d at 1116. "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any

> inference of bad faith. *See Software Toolworks*, 789 F.Supp. at 1504 n. 30.
>
> Here, Rossi's conclusory opinion . . . is not based on specific facts that shed light on the mental state of Deloitte's auditors. . . . Rather, Rossi is drawing his own conclusion based on a record that conclusively rebuts any inference of scienter. . . . As such, Rossi's opinion is more probative of Plaintiff's desperation to keep Deloitte, a "deep pocket," involved in this lawsuit than it is on the issue of whether Deloitte acted with scienter.

WOW, 814 F.Supp. at 870-71. We agree.

The plaintiffs presented no direct evidence that Deloitte acted with scienter. Nevertheless, the plaintiffs contend that summary judgment was inappropriate because their "expert" opined that Deloitte had done so. Inspection of the expert's declaration, however, reveals that he made an impermissible leap in logic to reach this conclusion.

Deloitte freely acknowledges that it had "full information" about the terms of the disputed transactions. Yet, as Deloitte explains, that knowledge is not dispositive:

> . . . Deloitte knew many facts because it did a diligent audit. But the issue is not whether Deloitte knew facts about transactions; it is whether Deloitte had "actual knowledge" of a misrepresentation, or whether Deloitte's resolution of the accounting issues presented by those facts was such "an extreme departure" from reasonable accounting practice that it "knew or had to have known" that its conclusions would mislead investors. *Hollinger*, 914 F.2d at 1569.

Rossi's disagreement with Deloitte's professional judgment does not meet that test.

In essence, the plaintiffs concede that Deloitte made a sufficient investigation into WOW's finances but contend that Deloitte's ultimate resolution of the accounting issues regarding those finances was incorrect. That contention is not sufficient to establish scienter. "[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." *Malone*, 26 F.3d at 479 (quotation omitted). *Accord, e.g., Vosgerichian v. Commodore Int'l*, 832 F.Supp. 909, 915 n. 8 (E.D.Pa.1993) ("The . . . complaint charges that [the accountants] . . . violated GAAP and GAAS, but clearly, even deliberate violations of those guidelines, without more, do not amount to fraud.") (collecting cases).

"[Scienter] requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *SEC v. Price Waterhouse*, 797 F.Supp. 1217, 1240 (S.D.N.Y.1992) (citations, quotations, and footnote omitted). As a result, Deloitte's evidence indicating that the accounting decisions were reasonable negates the plaintiffs' attempt to establish scienter. *See id.* at 1241 ("[The disputed] items involved complex issues of accounting as to which reasonable accountants could reach different conclusions. Indeed, . . . the Court heard diametrically opposing views from experts as to the reasonableness of [the] accounting

and audit judgments. It follows that no finding of fraud or recklessness can rationally be made in this case."); *Software Toolworks,* 789 F.Supp. at 1504 & n. 30 ("Plaintiffs . . . second guess Deloitte's decision that a 44% reserve was appropriate – this is not enough to infer scienter in this case. . . . Nor are Plaintiffs' expert's conclusory statements sufficient to defeat summary judgment."); *cf. Fine v. American Solar King Corp.,* 919 F.2d 290, 296-98 (5th Cir.1990) (triable issue regarding scienter exists where plaintiffs directly established that accountants *knew* they had violated GAAP by issuing false statements), *cert. dismissed,* ___ U.S. ___, 112 S.Ct. 576, 116 L.Ed.2d 601 (1991).

Rossi's conclusory allegations do not change this analysis. In sum, his declaration consists of self-righteous statements that, because Deloitte did not audit WOW as he would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient. *See WOW,* 814 F.Supp. at 871 n. 15 ("this is not the first time that a district court has awarded summary judgment to an auditor on the scienter issue in the face of a declaration by Rossi"); *Software Toolworks,* 789 F.Supp. at 1504-10 (same).[7]

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[7] The plaintiffs argue that we should be particularly sceptical [sic] of Deloitte's conduct in this case because the auditor had become "entangled" with WOW by offering discounts on its fees. This contention is utterly without merit:

> . . . It defies economic reality to suggest that a professional firm which extends a discount or does not bill its full fee for its "learning curve" in order to retain and accommodate a client has compromised its independence merely because it may colloquially

We affirm the district court's conclusion that Deloitte did not act with scienter.

C.

Finally, the plaintiffs argue that the Directors and the Shareholders violated section 10(b) by selling WOW securities with knowledge of undisclosed adverse, material information. A private right of action for insider trading exists under section 10(b) for persons who traded contemporaneously with the insider. *E.g., Neubronner v. Milken*, 6 F.3d 666, 670 (9th Cir.1993). To establish section 10(b) liability, however, the plaintiffs must prove that the insider traders acted with scienter. *E.g., Dirks v. SEC*, 463 U.S. 646, 663 & n. 23, 103 S.Ct. 3255, 3266 & n. 23, 77 L.Ed.2d 911 (1983). The district court exhaustively explained why the plaintiffs had not done so in this case:

> Plaintiffs assert that since these defendants sold some of their shares in WOW prior to

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> refer to that circumstance as an "investment" in the client. Indeed, this argument reflects the [plaintiff]'s general approach to this case, *i.e.*, to seize and grasp any fact to support any argument, however irrational, to justify its claim of fraud. . . .
>
> . . . It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees. The Court therefore declines the [plaintiff]'s invitation to look with a jaundiced eye at each accounting decision made during a complex audit merely because of an accountant's economic motivation in maintaining an ongoing relationship with a client.

Price Waterhouse, 797 F.Supp. at 1242 & n. 60 (citation omitted).

WOW's financial collapse, they must have known of some information, not already known to the market, that signalled WOW's imminent doom. Plaintiffs' "evidence," though, consists of mere speculation and conclusory allegations. . . .

. . . The evidence . . . shows only that the opportunity for insider trading existed. . . . In this case, after years of discovery, Plaintiffs cannot point to any bit of information traded on by these defendants that was not already known to the market. This speaks to the merits of their claims.

. . . "Insider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer,* 886 F.2d at 1117. But in this case, when one considers the amounts traded, Plaintiffs' claims appear fantastic. These defendants sold only a portion of their holdings in WOW. Of course, an insider may not always trade all his shares in the company for which he possesses the inside information; the trader may hold on to a portion of his shares to hedge against the unforeseen or to obscure the insider trading from the SEC. Here, however, Plaintiffs' allegation is essentially that these defendants possessed inside information on WOW's imminent collapse, so one would expect that they would have sold a good proportion of their holdings.

On the contrary, most of these defendants sold only a minuscule fraction of their holdings in WOW, and ended up reaping the same large losses as did Plaintiffs when WOW collapsed. . . .

> In sum, with this evidence, no reasonable jury could find that insider trading had occurred, or that these defendants acted with scienter.

WOW, 814 F.Supp. at 871-72. We agree.

Even if the evidence was sufficient to permit an inference that one or more of the defendants had access to inside information, the defendants' actual trading would conclusively rebut an inference of scienter. Director Margolis, several other partners in WOW Shares Partnership, and shareholder Robinson Interests sold their shares pursuant to a predetermined plan in accordance with SEC Rule 144. Robinson Interests, moreover, "sold its shares because it faced a pressing need to service a huge debt incurred from overinvesting in real estate." *WOW*, 814 F.Supp. at 872 n. 17. Other WOW Shares partners "who supposedly possessed inside information did not sell at all." *Id.* at 872. Director Howenstein "sold only 50,000 shares before WOW's bankruptcy, though he possessed over 970,000" shares at the time of the bankruptcy. *Id.* Shareholder Abercrombie started selling WOW shares (to raise cash for real estate improvements) *after* the announcement of large quarterly losses and, in total, still held onto eighty-six percent of her WOW stock (2,870,000 shares) at the time the corporation filed for bankruptcy.

"[This] pattern of stock trading . . . is insufficient to raise an issue for the jury. . . . Uncontradicted deposition testimony . . . provided credible and wholly innocent explanations for the stock sales, ranging from long-standing programs of periodic divestment, to the need to free cash to meet matured tax liabilities. These unrebutted explanations are sufficient to defeat any inference of bad

faith." *Apple Computer*, 886 F.2d at 1117. *See, e.g., Freeman v. Decio*, 584 F.2d 186, 197 n. 44 (7th Cir.1978) ("inference [of scienter] can be nullified by a showing that sales in question were consistent in timing and amount with a past pattern of sales or that other circumstances might reasonably account for their occurrence").

We therefore affirm the district court's conclusion that the Directors and the Shareholders are not liable for insider trading.[8]

V.

In conclusion, for the reasons stated by the district court in its excellent opinion, we affirm the summary judgment in favor of the defendants on all issues except the section 11 claim against Deloitte. We reverse and remand that claim, however, because the court applied an incorrect test of section 11(e) loss causation. In light of this remand, we also reinstate the plaintiffs' supplemental state-law claims against Deloitte.[9] All defendants other than Deloitte are awarded their costs.

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[8] In light of this conclusion, we need not consider the defendants' argument that, in any event, the plaintiffs cannot bring insider trading claims because they did not trade "contemporaneously" with the insiders. We do note, however, that recent Ninth Circuit authority indicates that the defendants' "contemporaneous trading" argument has significant merit. *See Neubronner*, 6 F.3d at 670 ("insider trading claims under section 10(b) and Rule 10b-5 is confined to persons who traded contemporaneously with the insider . . . [and] contemporaneous trading must be pleaded with particularity") (affirming dismissal of insider trading complaint).

[9] The plaintiffs also brought "controlling person" claims against various defendants. *See* 15 U.S.C. §§ 77o; 78t(a). We

AFFIRMED in part. REVERSED in part. REMANDED for proceedings consistent with this opinion.

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affirm the summary judgment on these claims because, as the district court noted, "[t]here being no primary violation, there can be no secondary violation." *WOW*, 814 F.Supp. at 872. Deloitte's potential section 11 liability does not change this conclusion because the plaintiffs did not allege that any defendant controlled the auditor.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In Re: WORLDS OF WONDER SECURITIES LITIGATION,	
ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, as Trustee for the Florida Municipal, Inc., Restated Defined Benefit Trust and Plan; SYLVIA WIND, on behalf of themselves and the certified class of purchasers of securities of Worlds of Wonder, Inc., Plaintiffs-Appellants, v. ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS, UPHAM & CO.; DEAN WITTER REYNOLDS, INC.; JOSEPHINE E. ABERCROMBIE; WORLDS OF WONDER SHARES PARTNERSHIP; ROBINSON INTERESTS, INC., Defendants-Appellees.	Nos. 93-15321; 93-15535 D.C. No. CV-87-05491-SC ORDER (Filed Mar. 27, 1995)

Before: FLETCHER, HALL and WIGGINS, Circuit Judges.

The panel has voted to deny appellants' petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

U.S. Const.

AMENDMENT VII – CIVIL TRIALS

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law.

15 U.S.C. § 77k. Civil liabilities on account of false registration statement

Persons possessing cause of action; persons liable

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue –

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration

statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Persons exempt from liability upon proof of issues

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof –

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action

and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not

misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

Standard of reasonableness

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

Effective date of registration statement with regard to underwriters

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

Measure of damages; undertaking for payment of costs

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to

the public) and the value thereof as of the time such suit was brought: *Provided,* That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

Joint and several liability

(f) All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

Offering price to public as maximum amount recoverable

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

May 27, 1933, c. 38, Title I, § 11, 48 Stat. 82; June 6, 1934, c. 404, Title II, § 206, 48 Stat. 907.

* * *

15 U.S.C. § 77l. Civil liabilities arising in connection with prospectuses and communications

Any person who –

* * *

> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

May 27, 1933, c. 38, Title I, § 12, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 9, 68 Stat. 686.

* * *

15 U.S.C. § 77o. Liability of controlling persons

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

May 27, 1933, c. 38, Title I, § 15, 48 Stat. 84; June 6, 1934, c. 404, Title II, § 208, 48 Stat. 908.

* * *

15 U.S.C. § 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * *

15 U.S.C. § 78t. Liability of controlling persons

Joint and several liability; good faith defense

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

* * *

* * *

17 C.F.R. §240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Fed.R.Civ.P. Rule 56. Summary Judgment

(a) For Claimant. A party seeking to recover upon a claim, counterclaim, or cross-claim or to obtain a declaratory judgment may, at any time after the expiration of 20 days from the commencement of the action or after service of a motion for summary judgment by the adverse party, move with or without supporting affidavits for a summary judgment in the party's favor upon all or any part thereof.

(b) For Defending Party. A party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in the party's favor as to all or any part thereof.

(c) Motion and Proceedings Thereon. The motion shall be served at least 10 days before the time fixed for the hearing. The adverse party prior to the day of hearing may serve opposing affidavits. The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. A summary judgment, interlocutory in character, may be rendered on the issue of liability alone although there is a genuine issue as to the amount of damages.

(d) Case Not Fully Adjudicated on Motion. If on motion under this rule judgment is not rendered upon the whole case or for all the relief asked and a trial is necessary, the court at the hearing of the motion, by examining

the pleadings and the evidence before it and by interrogating counsel, shall if practicable ascertain what material facts exist without substantial controversy and what material facts are actually and in good faith controverted. It shall thereupon make an order specifying the facts that appear without substantial controversy, including the extent to which the amount of damages or other relief is not in controversy, and directing such further proceedings in the action as are just. Upon the trial of the action the facts so specified shall be deemed established, and the trial shall be conducted accordingly.

(e) Form of Affidavits; Further Testimony; Defense Required. Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits. When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of the adverse party's pleading, but the adverse party's response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If the adverse party does not so respond, summary judgment, if appropriate, shall be entered against the adverse party.

(f) When Affidavits are Unavailable. Should it appear from the affidavits of a party opposing the motion

that the party cannot for reasons stated present by affidavit facts essential to justify the party's opposition, the court may refuse the application for judgment or may order a continuance to permit affidavits to be obtained or depositions to be taken or discovery to be had or may make such other order as is just.

(g) Affidavits Made in Bad Faith. Should it appear to the satisfaction of the court at any time that any of the affidavits presented pursuant to this rule are presented in bad faith or solely for the purpose of delay, the court shall forthwith order the party employing them to pay to the other party the amount of the reasonable expenses which the filing of the affidavits caused the other party to incur, including reasonable attorney's fees, and any offending party or attorney may be adjudged guilty of contempt.

ER 516 Ex. 23

$80,000,000

WOW
WORLDS OF WONDER

9% Convertible Subordinated
Debentures Due 2012

PROSPECTUS

June 4, 1987

Smith Barney,
Harris Upham & Co.
Incorporated

No dealer, salesman or any other person has been authorized to give any information or to make any representations other than those contained in this Prospectus in connection with the offer contained herein, and, if given or made, such information or representations must not be relied upon as having been authorized by the Company or the Underwriter. This Prospectus does not constitute an offer to sell any securities other than those to which it relates or an offer to sell, or a solicitation of an offer to buy, those to which it relates in any jurisdiction to any person to whom it is not lawful to make any such offer or solicitation in such jurisdiction. The delivery of this Prospectus at any time does not imply that the information herein is correct as of any time subsequent to its date.

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PROSPECTUS

$80,000,000

WOW
WORLDS OF WONDER

9% Convertible Subordinated Debentures Due 2012
Interest Payable June 1 and December 1

The Debentures are convertible into Common Stock of the Company at any time at or before maturity, unless previously redeemed, at a conversion price of $17.10 per share, subject to adjustment in certain events. The Company's Common Stock is listed on the NASDAQ National Market System under the symbol "WOWI." On June 3, 1987, the last reported sale price of the Common Stock on the NASDAQ National Market System was $14 1/4 per share.

The Debentures are redeemable for cash at any time on or after June 1, 1989 at the option of the Company, in whole or in part, at the redemption prices set forth in this Prospectus, together with accrued interest. The Debentures provide for annual mandatory sinking fund payments equal to 5% of the aggregate principal amount of the Debentures issued, commencing June 1, 1997, calculated to retire 75% of the principal amount of the Debentures prior to maturity. Each holder of the Debentures has the option to require the Company to redeem the holder's Debentures upon certain defined events. The Debentures are unsecured obligations of the Company and are subordinated to all Senior Indebtedness of the Company. The Underwriter has advised the Company that it currently intends to make a market in the Debentures. See "Description of Debentures."

Prospective investors should carefully review the information set forth under "Risk Factors."

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public (1)	Underwriting Discounts and Commissions (2)	Proceeds to Company (3)
Per Debenture	100%	2.5%	97.5%
Total (4)	$80,000,000	$2,000,000	$78,000,000

(1) Plus accured interest, if any, from June 11, 1987.

(2) See "Underwriting" for information concerning indemnification arrangements with the Underwriter.

(3) Before deducting expenses payable by the Company estimated at $640,000.

(4) The Company has granted to the Underwriter an option, exercisable within 30 days after the date of the Prospectus, to purchase up to an additional $12,000,000 principal amount of Debentures, to cover over-allotments, if any, at the Price to Public, less Underwriting Discounts and Commissions. If all such Debentures are purchased, the total Price to

Public, Underwriting Discounts and Commissions and Proceeds to Company will be $92,000,000, $2,300,000 and $89,700,000, respectively. See "Underwriting."

The Debentures are offered by the Underwriter named herein subject to prior sale, when, as and if delivered to and accepted by the Underwriter and subject to certain other conditions. It is expected that the Debentures will be available for delivery on or about June 11, 1987 at the office of Smith Barney, Harris Upham & Co. Incorporated, 110 Wall Street, New York, New York 10005.

Smith Barney, Harris Upham & Co.
Incorporated

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITER MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE DEBENTURES OFFERED HEREBY OR THE COMMON STOCK OF THE COMPANY OR BOTH AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

The following companies' trademarks are referred to herein. Worlds of Wonder, Inc.: Worlds of Wonder, Lazer Tag, Pamela, WOW Logo, The Talking Mother Goose, StarLyte, StarLyte Pro, Julie, The Magical Comes to Life, Over The Edge, Lazer Battle, Little Boppers, Class Act, Stuff-It, Rack-It, Sack-It, Express-It and Magic Trunk.

Sourcing International Limited (a wholly-owned subsidiary of the Company): Action Max. Greybridge (a wholly-owned subsidiary of the Company): Imaginaction, Squeezington Square, Creativity Wall and Block Sensations. Alchemy II, Inc.: Teddy Ruxpin, The World of Teddy Ruxpin, Grubby, Baby Teddy Ruxpin, Baby Grubby and Hector. United Features Syndicate: Peanuts, Snoopy and Woodstock. The Walt Disney Company: Mickey Mouse, Goofy, Minnie Mouse, Donald Duck, The Talking Mickey Mouse, The Talking Goofy and Winnie the Pooh. Henson Associates, Inc.: Jim Henson Muppets, Fraggle Rock, Muppet Magic, Muppet Babies, Kermit, Miss Piggy, Baby Kermit, Baby Miss Piggy, Baby Gonzo, Baby Fozzie and Baby Rowlf. Hasbro, Inc.: G.I. Joe. Canadian Solifuels, Inc.: Call My Bluff.

AVAILABLE INFORMATION

The Company is subject to the informational reporting requirements of the Securities Exchange Act of 1934 and in accordance therewith files reports and other information with the Securities and Exchange Commission. Such reports and other information may be inspected and copied at the Public Reference Room of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and at the Commission's regional offices at 219 South Dearborn Street, Chicago, IL 60604 and 26 Federal Plaza, New York, NY 10278. Copies of such material may be obtained from the Public Reference Section of the Commission, Washington, D.C. at prescribed rates.

The Company has filed with the Securities Exchange Commission, Washington, D.C., a Registration Statement

under the Act with respect to the securities offered hereby. This Prospectus does not contain all of the information set forth in the Registration Statement and the exhibits and schedules thereto. For further information with respect to the Company and such securities, reference is made to the Registration Statement, exhibits and schedules. Statements contained in this Prospectus as to the contents of any contract or any other document are not necessarily complete and, in each instance, reference is made to the copy of such contract or document filed as an exhibit to the Registration Statement. The Registration Statement, including exhibits thereto, may be inspected without charge at the Securities and Exchange Commission's principal office in Washington, D.C., and copies of it or any part thereof may be obtained from such office upon payment of the prescribed fees.

PROSPECTUS SUMMARY

The following summary is qualified in its entirety by the more detailed information and financial statements appearing elsewhere in this Prospectus.

The Company

Worlds of Wonder, Inc. is engaged primarily in the design, development, marketing and distribution of children's products. The Company's general strategy is to translate electronics-based technologies into innovative entertainment and leisure products that can be effectively promoted and distributed through mass market channels.

During its first fiscal year ended March 31, 1986, the Company produced and sold one product line. THE WORLD OF TEDDY RUXPIN, which has as its central character an animated story-telling plush toy named TEDDY RUXPIN. In fiscal 1987, the Company introduced a number of new toy product lines. The most successful was LAZER TAG, a game which uses infrared light technology. Other product lines included the electromechanical animation of the well-known children's characters MOTHER GOOSE, SNOOPY and MICKEY MOUSE, and PAMELA, a doll incorporating digital speech technology.

The Company's major products are positioned with character backgrounds and/or ongoing storylines so than an entire product line, composed of related characters, storybooks, cassette tapes, accessory clothing and/or various novelty items, can be created around the main product. The Company believes this strategy will help extend the life cycle of its product lines and generate greater sales volume.

The Company has announced for calendar 1987 a variety of new product lines, encompassing toys, video products, school accessories and pre-school toys, that can be promoted and distributed through mass market channels.

The Offering

Securities Offered.....	$80,000,000 principal amount of 9% Convertible Subordinated Debentures Due 2012 (the "Debentures").

Interest Payment Dates	June 1 and December 1, commencing December 1, 1987.
Conversion Rights	Convertible into Common Stock of the Company at the option of the holder, at any time on or before maturity, unless previously redeemed, at a conversion price of $17.10 per share, subject to adjustment under certain conditions.
Optional Redemption	The Debentures are redeemable for cash, in whole or in part, at the option of the Company at any time, on or after June 1, 1989 at the redemption prices set forth herein, together with accrued interest.
Mandatory Redemption	The Debentures may be redeemed at the option of the holders thereof, in whole or in part, upon the occurrence of certain acquisitions of the voting securities of the Company or upon certain consolidations, mergers or similar transactions of the Company, if not approved by the Company's Board of Directors. See "Description of Debentures – Mandatory Redemption."

Sinking Fund	Mandatory annual payments sufficient to retire 5% of the aggregate principal amount of the Debentures originally issued will be made each year, commencing June 1, 1997, calculated to retire 75% of the Debentures prior to maturity.
Subordination	Subordinated to all Senior Indebtedness (as defined).
Use of Proceeds	To repay outstanding bank indebtedness and for general corporate purposes. See "Use of Proceeds."

Summary Consolidated Financial Data
(In thousands, except per share and ratio data)

	Year Ended March 31,	
	1986	1987
Income Statement Data:		
Net sales	$93,087	$327,422
Operating costs and expenses	75,891	297,869
Income before taxes on income	15,274	28,893
Net income	3,102	18,640
Net income per share	.43	.85
Ratio of earnings to fixed charges:		
Actual (1)	11.1	6.6
Pro forma(2)	–	3.6

	March 31, 1986	March 31, 1987 Actual	March 31, 1987 As Adjusted (3)
Balance Sheet Data:			
Working capital	$4,971	$ 69,650	$147,010
Total assets	70,261	272,987	278,358
Short-term debt	23,739	71,989	–
Long-term debt.....	–	–	80,000
Shareholders' equity..	11,624	98,859	98,859

(1) For purposes of computing the ratio of earnings to fixed charges, earnings consist of income from operations before income taxes and fixed charges. Fixed charges consist of interest expense, financing charges and one-third of total rent expense.

(2) The pro forma ratio of earnings to fixed charges for the year ended March 31, 1987 gives effect to annual interest on the Debentures (assuming no exercise of the Underwriter's over-allotment option), the amortization of deferred financing charges and the elimination of annual interest on indebtedness to be repaid with the proceeds of this offering.

(3) Adjusted to reflect the sale of the Debentures (assuming no exercise of the Underwriter's over-allotment option) and the anticipated use of the estimated net proceeds.

The Company intends to seek shareholder approval at the next annual meeting of shareholders to reincorporate in Delaware. See "Management – Reincorporation in Delaware and Limitation of Liability and Indemnification Matters."

THE COMPANY

Worlds of Wonder, Inc. is engaged primarily in the design, development, marketing and distribution of children's products. The Company's general strategy is to translate electronics-based technologies into innovative entertainment and leisure products that can be effectively promoted and distributed through mass market channels.

During its first fiscal year ended March 31, 1986, the Company produced and sold one product line, THE WORLD OF TEDDY RUXPIN, which has as its central character an animated story-telling plush toy named TEDDY RUXPIN. In fiscal 1987, the Company introduced a number of new toy product lines. The most successful was LAZER TAG, a game which uses infrared light technology. Other product lines included the electromechanical animation of the well-known children's characters MOTHER GOOSE, SNOOPY and MICKEY MOUSE, and PAMELA, a doll incorporating digital speech technology.

The Company's major products are positioned with character backgrounds and/or ongoing storylines so that an entire product line, composed of related characters, storybooks, cassette tapes, accessory clothing and/or various novelty items, can be created around the main product. The Company believes this strategy will help extend the life cycle of its product lines and generate greater sales volume.

The Company has announced for calendar 1987 a variety of new product lines, encompassing toys, video products, school accessories and pre-school toys, that can be promoted and distributed through mass market channels.

Worlds of Wonder was incorporated under the laws of California in March 1985. Its corporate headquarters are located at 4209 Technology Drive, Fremont, California 94538 and its telephone number is (415) 659-4300. Unless the context indicates otherwise, references to the "Company" or "Worlds of Wonder" herein include Worlds of Wonder, Inc. and its consolidated subsidiaries. The Company intends to seek shareholder approval at the next annual meeting of shareholders to reincorporate in Delaware. See "Management – Reincorporation in Delaware and Limitation of Liability and Indemnification Matters."

RISK FACTORS

Prospective investors should carefully consider the following factors before purchasing the Debentures offered by this Prospectus.

New Product Development and Introduction. The product life cycle of a toy line is in general relatively short. Successful new products and product lines are therefore crucial to the success of the Company's business. The Company has limited experience in product development and introduction, and product line expansion will place great demands on management and other Company resources. If the Company's current product lines lose market acceptance and are not replaced successfully with new products, the Company's business would be adversely affected. Although the Company is planning to introduce several major new products and product lines, there can be no assurance that such new products and product lines will be successful. See "Business – Current Products;

– New Products; and – Product Development and Design."

Product Diversification. Since its inception, the Company has derived substantially all of its net sales from toy products. However, the Company has developed and continues to develop products other than toys that it believes can be effectively promoted and distributed through mass market channels. Developing such products involves significant senior management time and Company resources. New products may utilize different technologies and require knowledge of markets in which the Company does not presently participate. See "Business – New Products; and – Product Development and Design."

Short Operating History. The Company has a short operating history, having commenced operations in April 1985. The Company achieved approximately $93 million and $327 million in net sales and $8.1 million and $18.6 million in net income during its fiscal years ended March 31, 1986 and 1987, respectively. However, its operations are subject to a number of risks, some of which are summarized herein. Accordingly, there can be no assurance that the Company will continue to experience rapid growth in net sales or remain profitable.

Dependence on Independent Designers; Royalty Obligations. A majority of the Company's product lines are created by or employ characters created by outside designers. The Company intends to continue to seek product ideas and to contract for product development work from third parties, pursuant to agreements which in some instances provide for the retention of ownership of

the development work by the independent designer and the grant of a license to the Company in exchange for royalty payments. Such payments are generally based upon net sales of the product by the Company for the duration of the license and, depending upon revenue generated from the sale of the product, may be substantial. Furthermore, certain agreements require advances by the Company against future royalties to aid the designer in funding development costs. The inability to obtain these licenses on reasonable terms could adversely affect the Company. See "Business – Product Development and Design."

Competition. The toy industry is highly competitive. Among the Company's competitors are toy companies and toy divisions of large diversified companies with greater assets and resources than those of the Company, as well as hundreds of smaller domestic and foreign toy manufacturers, importers and marketers. The relatively low barriers to entry into the toy industry also permit new competitors to enter the industry easily. The Company believes it initially enjoyed limited competition to its TEDDY RUXPIN product line. Due to the success of TEDDY RUXPIN, however, other companies have introduced talking toy products that compete with TEDDY RUXPIN and other animated products introduced by the Company. Such entrants might force price reductions or cause the Company to lose market share, which events may adversely affect the Company. LAZER TAG and PAMELA have faced more immediate and significant competition than that faced by the TEDDY RUXPIN product line in fiscal 1986. Additionally, many of the recently

announced new products may face significant competition in their respective markets. See "Business – Competition."

Seasonality of Quarterly Results. Sales of toys are highly seasonal, with a majority of retail sales occurring during the Christmas season. Although indications of interest are provided by retailers early in the year, subsequent orders are generally cancellable without penalty. The seasonality of sales may cause operating results and working capital requirements to vary significantly from quarter to quarter. The Company anticipates that net sales for the quarter ending June 30, 1987 will be less than those for each of the prior three quarters, and the Company expects to report a loss for the quarter. See "Management's Discussion and Analysis of Financial Condition and Results of Operations." There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in seasonal demand. See "Business – Seasonality and Backlog."

Dependence on Foreign Contract Manufacturers. The Company currently conducts substantially all of its manufacturing operations through unaffiliated contract manufacturers in Hong Kong, the People's Republic of China, Taiwan and Korea. Foreign manufacturing is subject to a number of risks, including transportation delays and interruptions, political and economic disruptions, labor strikes, the imposition of tariffs and import and export controls, currency realignments and changes in governmental policies. The Company uses a limited number of

manufacturers for each product line and accordingly is dependent upon sources outside the Company for timely production and quality workmanship. There can be no assurance that unusual delays or quality control problems of such manufacturers may not delay product deliveries or result in product returns, resulting in losses of revenues and goodwill. Although the Company believes other contract manufacturers would be available upon acceptable terms if the need were to arise, the Company's operations could be adversely affected by a substantial delay in locating acceptable substitutes or increasing the production of alternative manufacturers. See "Business – Manufacturing."

Limited Component Sources. Certain electronic components included in the Company's products are available from a single source or limited sources. Although in certain instances the Company has arranged for the sole suppliers of the parts to carry additional inventories, interruption in the supply of components could adversely affect the Company. See "Business – Manufacturing."

Dependence on Key Personnel and New Employees. The Company believes its success will depend to a significant extent on the efforts and abilities of certain of its senior management, in particular those of Donald Kingsborough, its Chairman of the Board and Chief Executive Officer, and Angelo Pezzani, its President and Chief Operating Officer. The loss of Mr. Kingsborough's or Mr. Pezzani's services or of certain other key management or technical employees could have a material adverse effect on the Company. The Company's success also depends upon its ability to attract and retain qualified employees. See "Business – Employees" and "Management."

Capital Requirements. The Company's existing bank line of credit and import financing line expire September 30, 1987 and December 31, 1987, respectively. To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts under these lines, both of which its expects to replace or extend prior to expiration. The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities presently being negotiated, will provide sufficient funds to meet the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on acceptable terms, its operations would be adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

Systems and Control Procedures Requirements. The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures and controls to meet the demands of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with growth.

Shares Eligible for Future Sale. Of the 22,224,071 shares of Common Stock of the Company outstanding at March 31, 1987, approximately 7,360,000 shares were eligible for sale in the open market without restriction. Of

the remaining outstanding shares of Common Stock (the "Restricted Shares"), approximately 10,910,000 shares are currently eligible for sale from time to time in the public market under the restrictions of Rule 144 promulgated under the Securities Act of 1933, as amended (the "1933 Act"). Approximately 1,440,000 additional Restricted Shares become eligible for such sale under the restrictions of Rule 144 at various times in August 1987. See "Description of Capital Stock – Shares Eligible for Future Sale." Any substantial sales of Common Stock in the public market following this offering could adversely affect the market price of the Common Stock and the Debentures.

USE OF PROCEEDS

The net proceeds from the sale of the Debentures offered by the Company are estimated to be $77,360,000 ($89,060,000 assuming the Underwriter's over-allotment option is exercised in full). The net proceeds will be applied to repay outstanding short-term bank debt, and any remaining net proceeds will be used for general corporate purposes. The short-term bank debt, which was approximately $80 million at June 3, 1987, was incurred by the Company to fulfill general working capital needs. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

Until the net proceeds are used as set forth above, the Company intends to invest the net proceeds of this offering in short-term interest bearing obligations and other marketable securities.

PRICE RANGE OF COMMON STOCK

The Company's Common Stock has been traded in the over-the-counter market under the NASDAQ symbol WOWI since the Company's initial offering of its Common Stock to the public at $18.00 per share on June 20, 1986. The following table sets forth, for the periods indicated, the range of high and low closing bid prices for the Common Stock until July 1, 1986, at which time the Common Stock was included in the NASDAQ National Market System, and the high and low sale prices as reported by NASDAQ for the Common Stock on and after such date. Prices prior to July 1, 1986 represent quotations between dealers without adjustment for retail markups, markdowns or commissions, and may not represent actual transactions.

Fiscal Year Ended March 31,	High	Low
1987:		
First Quarter (from June 20, 1986)	$29	$24 1/4
Second Quarter	26 1/2	16 1/2
Third Quarter	26 1/2	19
Fourth Quarter	24 1/4	18 1/2
1988:		
First Quarter (through June 3, 1987)	20	13 1/2

On June 3, 1987, the last sale price of the Company's Common Stock, as reported on the NASDAQ National Market System, was $14 1/4 per share.

DIVIDEND POLICY

The Company has never paid cash dividends on its Common Stock. The Board of Director's current policy is to retain all earnings for use in the Company's business. The Company's ability to declare and pay dividends is currently prohibited by financial covenants in its bank credit agreement. See Note 3 of Notes to Consolidated Financial Statements.

CAPITALIZATION

The following table sets forth the short-term debt and capitalization of the Company as of March 31, 1987, and as adjusted to reflect the sale of the Debentures offered by the Company hereby and the application of the net proceeds thereof.

	March 31, 1987	
	Actual	As Adjusted
	(In thousands)	
Short-term bank debt (1)	$71,989	$ –
Long-term debt:		
9% Convertible Subordinated Debentures Due 2012	$ –	$ 80,000
Shareholders' equity:		
Preferred Stock: 1,000,000 shares authorized; no shares outstanding	–	–
Common Stock: 50,000,000 shares authorized; 22,224,071 outstanding (2)	72,117	72,117
Retained Earnings	26,742	26,742
Total shareholders' equity	98,859	98,859
Total capitalization	$98,859	$178,859

(1) Short-term bank debt at June 3, 1987 was approximately $80 million. See Note 3 of Notes to Consolidated Financial Statements.

(2) Does not include 1,851,442 shares of Common Stock reserved for future issuance pursuant to the 1985 Incentive Stock Option Plan, of which 1,285,192 shares were subject to outstanding options as of March 31, 1987. See "Management – Employee Stock Plans."

SELECTED CONSOLIDATED FINANCIAL DATA

The selected financial data presented below should be read in conjunction with the Company's consolidated

financial statements and related notes and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere herein. The financial data (except ration of earnings to fixed charges) have been derived from the consolidated financial statements for the fiscal years ended March 31, 1986 and 1987, which statements have been examined by Deloitte Haskins & Sells, independent public accountants, as indicated in their opinion included elsewhere herein.

	Year Ended March 31,	
	1986	1987
	(In thousands, except per share and ratio data)	
Income Statement Data:		
Net sales	$93,087	$327,422
Operating costs and expenses:		
Cost of sales	52,701	207,732
Advertising and promotion	11,802	50,669
Selling and distribution	6,044	20,732
General and administrative	5,344	18,736
Total operating costs and expenses	75,891	297,869
Income from operations	17,196	29,553
Interest expense, net	(1,302)	(3,439)
Other income (expense), net	(620)	2,779
Income before taxes on income	15,274	28,893
Taxes on income	7,172	10,253
Net income	$ 8,102	$ 18,640
Net income per share (1)	$ .43	$ .85
Shares used in computing net income per share (1)	18,876	21,923

Ratio of earnings to fixed charges:		
Actual (2)	11.1	6.6
Pro forma (3)	–	3.6

	March 31,	
	1986	1987
	(In thousands)	
Balance Sheet Data:		
Working capital	$ 4,971	$ 69,650
Total assets	70,261	272,987
Short-term bank debt	20,088	71,989
Subordinated debt (4)	3,651	–
Long-term debt	–	–
Retained earnings	8,102	26,742
Shareholders' equity	11,624	98,859

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(1) See Note 1 of Notes to Consolidated Financial Statements for information concerning the per share calculations.

(2) For purposes of computing the ratio of earnings to fixed charges, earnings consist of income from operations before income taxes and fixed charges. Fixed charges consist of interest expense, financing charges and one-third of total rent expense.

(3) The pro forma ratio of earnings to fixed charges for the year ended March 31, 1987 gives effect to annual interest on the Debentures (assuming no exercise of the Underwriter's over-allotment option), the amortization of deferred financing charges and the elimination of annual interest on indebtedness to be repaid with the proceeds of this offering.

(4) See "Management – Certain Transactions" for a discussion of the terms of the subordinated debt.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

The following table sets forth unaudited income statement data by quarter for the fiscal years ended March 31, 1986 and 1987:

	Year Ended March 31, 1986				Year Ended March 31, 1987			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands)							
Net sales	$ –	$ 2,695	$45,800	$44,592	$23,485	$61,708	$132,771	$109,458
Operating costs and expenses:								
Cost of sales	191	2,117	25,853	24,540	14,696	38,784	80,641	73,611
Advertising and promotion	376	1,299	4,420	5,707	4,933	8,507	15,771	21,458
Selling and distribution	215	507	2,727	2,595	2,270	5,076	7,094	6,292
General and administrative	840	1,140	1,086	2,278	2,653	3,175	6,270	6,638
Total operating costs and expenses	1,622	5,063	34,086	35,120	24,552	55,542	109,776	107,999

The Company commenced operations in April 1985. During the period from April through August 1985, the Company concentrated its efforts on staffing key positions, developing its initial product line, marketing and promoting the product line, obtaining sales orders, securing supply and manufacturing commitments and obtaining financing. The first shipments of THE WORLD OF TEDDY RUXPIN were delivered in late August 1985. Because limited sales were recorded in the first two quarters of fiscal 1986, a comparison of the results of operations for the years ended March 31, 1986 and 1987 would not be meaningful. Therefore, the following sets forth a discussion of the Company's operations by quarter. The following table sets forth unaudited income statement data as a percentage of net sales for the third and fourth quarters of fiscal 1986 and for each quarter of fiscal 1987:

Net Sales

Sales of toys are highly seasonal, with a majority of retail sales occurring during the Christmas season. The seasonality of sales has in part caused, and may continue to cause, operating results and working capital requirements to vary significantly from quarter to quarter.

In the third quarter of fiscal 1986, which ended on December 31, 1985, net sales were $45.8 million. In addition to the six storybook/tapes released with the introduction of TEDDY RUXPIN, an additional six titles were released in late October 1985.

Although the post-Christmas quarter is a traditionally slow period for the toy industry, the Company recorded net sales of $44.6 million for the quarter ended March 31, 1986, or 97% of the preceding quarter's net sales. Because the Company's pre-Christmas sales were constrained by production capacity, many retailers experienced out-of-stock positions of the Company's products during the entire Christmas season. Consequently, demand for the products remained high after Christmas. In the fourth quarter, the Company also released additional accessories for THE WORLD OF TEDDY RUXPIN line and began shipping products for distribution into international markets.

Sales for the first quarter of fiscal 1987, comprising only products from THE WORLD OF TEDDY RUXPIN were $23.5 million. In the second quarter of fiscal 1987, net sales increased to $61.7 million as retailers began purchasing for the Christmas season. The increased sales level reflected strong demand for TEDDY RUXPIN and

the introduction in limited quantities of LAZER TAG late in the quarter.

The Company completed the third quarter of fiscal 1987 with over $132.7 million in net sales, a 190% increase over net sales of the same quarter of fiscal 1986. Along with the success of LAZER TAG and continued strong demand for TEDDY RUXPIN, the Company introduced in limited quantities THE TALKING MOTHER GOOSE, THE TALKING SNOOPY, THE TALKING MICKEY MOUSE, the PAMELA doll and accessories for LAZER TAG. Additionally, the Company offered a program in late December which allowed retailers to purchase products in containers F.O.B. Hong Kong. Net sales were approximately $20 million under this program.

Net Sales of $109.5 million in the fourth quarter of fiscal 1987 included substantial quantities of TEDDY RUXPIN, LAZAR TAG, THE TALKING MOTHER GOOSE, THE TALKING SNOOPY, THE TALKING MICKEY MOUSE and PAMELA. As the Company believes is common in the toy industry, the Company offered "dating" on approximately $52 million of fourth quarter sales, extending payment terms to December 1987. Approximately $17 million of such sales were shipped F.O.B. Hong Kong. During the fourth quarter, the Company also recorded approximately $9 million of net sales of discontinued products which were exchanged for future media time.

Because sales of toys are highly seasonal, the Company would generally expect net sales to be lower in the first half of the calendar year. The Company's net sales in the first quarter of fiscal 1987 were lower than net sales in

each of the preceding two quarters. Similarly, the Company expects net sales for the first quarter of fiscal 1988 to be lower than sales for each of the prior three quarters. At the same time, the Company is continuing to expand its operations in anticipation of the Christmas selling season. As a result, the Company expects to report a net loss for the first quarter of fiscal 1988 proportionately greater than the net loss reported for the first quarter of fiscal 1987.

Operating Costs and Expenses

The major components of cost of sales are direct contract manufacturing product costs, freight to the U.S., royalties, manufacturing administration and quality control. Cost of sales as a percentage of net sales was higher in each quarter of fiscal 1987 than in fiscal 1986. The higher cost of sales percentages resulted primarily from: higher direct product costs for finished goods, purchased from contract manufacturers; changes in the product mix; a higher percentage of international sales to distributors, which sales carry lower gross margins; increased manufacturing overhead to accommodate current and expected growth; and, in the fourth quarter of 1987, charges for shrinkage and other inventory adjustments and a decrease in the sales price of TEDDY RUXPIN. These were offset in part by proportionately lower warranty, air freight and royalty costs.

The Company believes the demand for its products is sensitive to advertising and promotion, and significant amounts are committed to this area. These expenditures were higher in fiscal 1987 than in the prior year primarily

due to the introduction of a larger number of new products. The Company allocates its budgeted television commercial costs (exclusive of production costs), which account for the majority of advertising and promotion expense, on a quarterly basis over each fiscal year in accordance with anticipated sales levels. As a percentage of net sales, television commercial costs remained relatively constant during the first three quarters of fiscal 1987 but increased sharply in the fourth quarter, reflecting higher than budgeted expenditures to support existing products and to launch new products which first became available for shipment in significant quantities in the fourth quarter. Other advertising and promotion expenditures increased in every quarter of fiscal 1986 and 1987, reflecting increases in personnel, and expanded marketing and other promotional activities. Such increases were made to accommodate new product lines introduced in fiscal 1987, as well as products to be introduced in fiscal 1988.

Selling and distribution expenses increased substantially in fiscal 1987 as compared with fiscal 1986 due to increases in sales and distribution personnel, expanded warehousing and distribution facilities and the initiation of the Company's National Merchandising Program in early fiscal 1987. Quarter to quarter variations in selling and distribution expenses reflect sales commissions on varying sales levels; increased fixed administration expenses to support greater sales volumes; and in the third and fourth quarters of fiscal 1987, the expansion of the National Merchandising Program. As a percentage of net sales, such expenses have been relatively higher in periods of seasonally low sales.

General and administrative expense includes product design and development, corporate and legal, finance and accounting, human resources and administration. Total general and administrative expense increased every quarter in fiscal 1987 reflecting engineering efforts relating to new products introduced in fiscal 1987; ongoing new product development expansion of facilities; and increases in personnel in all functional areas to accommodate the Company's growth. Fourth quarter increases were offset in part by reductions of bonuses accrued during the year.

Interest Expense, Other Income and Expense and Taxes on Income

The Company incurred interest expense on borrowings under its bank line, on subordinated debt and on outstanding payables and standby letters of credit issued to certain vendors. Interest expense increased every quarter through the first quarter of fiscal 1987. In June 1986, the Company raised approximately $66.5 million from its initial public offering of Common Stock. Proceeds from the offering allowed the Company to repay subordinated debt and borrowings under its bank lines. Therefore, interest expense declined substantially in the second and third quarters of fiscal 1987. Interest expense increased significantly in the fourth quarter, as the Company required greater borrowings to finance substantially higher accounts receivable generated from sales during the Christmas selling season and to finance higher inventory levels.

The Company incurred net other expense in each quarter through the first quarter of fiscal 1987. In the remaining quarters of fiscal 1987, the Company generated net other income, primarily from commissions on sales of Nintendo products and from royalties on licensing of the TEDDY RUXPIN and LAZER TAG names for use by non-toy manufacturers and others.

Taxes on income reflect an annual effective tax rate of 47.0% for fiscal 1986. Taxes on income in the first three quarters of fiscal 1987 were provided at an average estimated effective rate of 37.0%. This rate was adjusted to an annual effective rate of 35.5% in the fourth quarter, resulting in a net tax benefit for that quarter. The decrease in the overall rate for fiscal 1987 reflects primarily the lower tax rates applicable to earnings of the Company's Hong Kong subsidiaries as compared to the rate applicable to its U.S. operations.

The Company's business is not capital intensive. Therefore, it anticipates that the negative impact on earnings of the Tax Reform Act of 1986, as amended, arising from such matters as the elimination of the investment tax credit and the change in depreciation schedules will generally be offset by the positive impact of the lower tax rate. The overall effects of such changes are difficult to measure at this time.

Liquidity and Capital Resources

Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support its growth. The Company has met in

capital requirements to date primarily through borrowings under bank lines of credit, the private and public sale of equity securities and borrowings under subordinated notes payable to shareholders.

The Company entered into an agreement in June 1986 with a syndicate of banks for a secured line of credit which expires September 30, 1987. The Company can borrow up to the lesser of $110 million or 75% of eligible accounts receivable. At June 3, 1987, the Company had outstanding borrowings of approximately $80 million, representing the maximum amount available under the borrowing limits of its bank line of credit.

In addition to the bank line of credit, the Company recently negotiated a $35 million unsecured import financing line which expires on December 31, 1987. As of June 3, 1987, the Company had standby letters of credit of approximately $32 million outstanding under this line.

To meet seasonal working capital requirements, management expects to continue to borrow substantial amounts under its bank line of credit and its import financing line, both of which it expects to replace or extend prior to expiration. Based on its current plan of operations, management anticipates that existing credit facilities and new bank facilities presently being negotiated, together with the proceeds of the offering of the Debentures and funds from operations, will be sufficient to meet the Company's short-term cash requirements through March 31, 1988. The banks with which the Company is currently negotiating new facilities have indicated that the exercise of the mandatory redemption option by holders of Debentures will constitute an event

of default under such new facilities. See "Description of Debentures – Mandatory Redemption." There are currently no significant commitments for capital expenditures.

BUSINESS

Worlds of Wonder is engaged primarily in the design, development, marketing and distribution of toys and other children's products. The Company's general strategy is to translate electronics-based technologies into innovative entertainment and leisure products that can be effectively promoted and distributed through mass market channels.

During its first fiscal year ended March 31, 1986, the Company produced and sold one product line, THE WORLD OF TEDDY RUXPIN, which has as its central character an animated story-telling plush toy named TEDDY RUXPIN. In fiscal 1987, the Company introduced a number of new toy product lines. The most successful was LAZER TAG, a game which uses infrared light technology. Other product lines included the electromechanical animation of the well-known children's characters MOTHER GOOSE, SNOOPY and MICKEY MOUSE, and PAMELA, a doll incorporating digital speech technology.

The Company's feature products are positioned with character backgrounds and/or ongoing storylines so that entire product lines, composed of related characters, storybooks, cassette tapes, accessory clothing and/or various novelty items, could be created around the main product. The Company believes this strategy will help

Income (loss) from operations	(1,622)	(2,368)	11,714	9,472	(1,067)	6,166	22,995	1,459
Interest expense, net	(42)	(147)	(329)	(784)	(933)	(80)	(461)	(1,965)
Other income (expense), net	(2)	(99)	(97)	(422)	(52)	277	1,760	794
Income (loss) before taxes on income	(1,666)	(2,614)	11,288	8,266	(2,052)	6,363	24,294	288
Taxes (benefit) on income	–	–	3,436	3,736	(780)	2,288	9,076	(331)
Net income (loss)	$(1,666)	$(2,614)	$ 7,852	$ 4,530	$(1,272)	$ 4,075	$ 15,218	$ 619

	Year Ended March 31, 1986		Year Ended March 31, 1987			
	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Operating costs and expenses:						
Cost of sales	56.4	55.0	62.6	62.9	60.7	67.3
Advertising and promotion	9.7	12.8	21.0	13.8	11.9	19.6
Selling and distribution	6.0	5.8	9.6	8.2	5.4	5.7
General and administrative	2.4	5.1	11.3	5.1	4.7	6.1
Total operating costs and expenses	74.5	78.7	104.5	90.0	82.7	98.7
Income (loss) from operations	25.5	21.3	(4.5)	10.0	17.3	1.3
Interest expense, net	(.7)	(1.8)	(4.0)	(.1)	(.3)	(1.8)
Other income (expense), net	(.2)	(.9)	(.2)	.4	1.3	.8
Income (loss) before taxes on income	24.6	18.6	(8.7)	10.3	18.3	.3
Taxes (benefit) on income	7.5	8.4	(3.3)	3.7	6.8	(.3)
Net income (loss)	17.1%	10.2%	(5.4)%	6.6%	11.5%	.6%

extend the life cycle of its product lines and generate greater sales volume.

The Company has announced for calendar 1987 a variety of new product lines, encompassing toys, video products, school accessories and pre-school toys, that can be promoted and distributed through mass market channels.

Current Products

Electromechanical Animation Products

THE WORLD OF TEDDY RUXPIN. TEDDY RUXPIN is an animated story-telling plush character. TEDDY RUXPIN "comes to life" through an electromechanical animation technology which synchronizes eye, nose and mouth movements to the toy's corresponding speech patterns using pre-programmed cassette tapes. The dual track cassette tapes are played on a specifically modified cassette player built into the product.

THE WORLD OF TEDDY RUXPIN encompasses several other characters. These characters are featured in a series of adventures recorded on cassette tapes accompanied by storybooks. TEDDY RUXPIN's best friend GRUBBY is a plush "octopede." When alone, GRUBBY is inanimate, but an electronic cord which attaches to TEDDY RUXPIN allows the two characters to have animated conversations. Other accessories to the line include clothing outfits for TEDDY RUXPIN, non-animated characters from THE WORLD OF TEDDY RUXPIN and other related accessories.

The characters in THE WORLD OF TEDDY RUXPIN and the talking toy technology are licensed by the Company on an exclusive basis from Alchemy II, Inc. ("Alchemy"). See "Product Development and Design – Alchemy."

THE TALKING MOTHER GOOSE. Positioned for a slightly younger audience than that of TEDDY RUXPIN, THE TALKING MOTHER GOOSE is an animated storytelling plush goose which recites fairy tales and nursery rhymes. THE TALKING MOTHER GOOSE line includes accessory storybooks and tapes of classic fairy tales.

PEANUTS characters. The Company has the exclusive, worldwide rights to develop, manufacture and sell electromechanical plush versions of characters from the syndicated comic strip PEANUTS by Charles M. Schulz. See "Product Development and Design – Character Licenses." THE TALKING SNOOPY (with a built-in specifically modified cassette player) and WOODSTOCK characters were introduced in fiscal 1987. The line also includes accessory clothing and storybooks and tapes for SNOOPY.

Disney characters. The Company has the exclusive rights to manufacture and sell mechanical talking plush toy versions of the Disney characters in the United States. See "Product Development and Design – Character Licenses." In fiscal 1987, the Company introduced its first Disney character. THE TALKING MICKEY MOUSE, along with accessory clothing and storybooks and tapes.

Lazer Tag

A LAZER TAG game kit comprises a hand-held STARLYTE that emits a harmless infrared light beam, a "sensor" which detects when the infrared beam is directed at it, and a holster. The sensor may be used as a stationary target or be worn by the participant to play a futuristic game of tag. When the sensor is "tagged," a sound and a display register the tag. Each sensor also has a bank of oscillating displays for visibility and a variable heartbeat sound which accelerate with each of six successive tags until the participant is "out." In addition to game kits, the Company also markets a complement of sensors and accessories for LAZER TAG.

Pamela

PAMELA is a doll incorporating digital speech technology through a custom microcontroller which contains a proprietary method of speech synthesis. When spoken to, PAMELA responds with a randomly selected sentence. In addition, when one of the six sensors on her face is touched, she speaks a randomly selected sentence related to the facial feature touched. PAMELA is designed to accept specially produced voice cards which change her vocabulary, allowing the development of additional sentences adapted to specific themes (e.g., PAMELA goes to school, the beach, a party). The voice cards and additional clothing outfits for the doll are sold separately.

New Products

The product life cycle of a toy line is in general relatively short. Accordingly, the Company's success will be dependent in large part on its ability, as to which there can be no assurance, to introduce new toy and other products in a timely and efficient manner and to extend the life cycle of existing products. The Company has announced new products for calendar 1987 in the following categories: toys, video products, school accessories and pre-school toys.

Toys

The Company announced its new toys for the 1987 Christmas season at the February 1987 New York Toy Fair. Prototypes of the new products have been developed and shown to many key retail buyers. The Company expects the manufacture of most of these toys to begin in the summer of 1987 with initial shipments of these products to retailers staggered from July through October. However, the timing of retail availability may be affected by accelerations or delays in the production cycle in the normal course of business, as well as decisions regarding the method of shipment of products from manufacturing facilities in the Far East. The new products announced for the 1987 Christmas season include the following:

Line extensions. In keeping with its general product strategy, the Company announced a large number of products and accessories to accompany and extend its current toy lines. These include: BABY TEDDY RUXPIN and BABY GRUBBY, plush voice-activated talking characters from THE WORLD OF TEDDY RUXPIN; HECTOR, a

plush "ugly duckling" with an animation cord which attaches to THE TALKING MOTHER GOOSE; THE TALKING GOOFY, a plush Disney character with an animation cord which attaches to THE TALKING MICKEY MOUSE: additional accessory storybooks, cassette tapes and clothes for the Company's electromechanical talking toys; and a new LAZER TAG unit (the STARLYTE PRO), an array of targets and other accessories for LAZER TAG.

MUPPET MAGIC. The Company has the exclusive rights to manufacture and sell in the United States and Canada talking and animated toys and related ancillary products based upon certain characters originally created by Henson Associates, Inc. The MUPPET MAGIC product line represents a new type of animation technology. This technology involves the use of a remote cassette player located in the MAGIC TRUNK, which transmits radio signals allowing MUPPET BABIES characters to tell stories, sing songs and move their eyes and mouths without the need for connecting cords or wires. The MAGIC TRUNK comes with Talking BABY KERMIT. Other characters that will be sold separately are Talking BABY MISS PIGGY, Talking BABY GONZO, Talking BABY FOZZIE and Talking BABY ROWLF. The line also includes six separate storybooks and cassette tapes.

JULIE is an animated doll with 128K of resident memory which incorporates voice and word recognition, synthesized speech technology and a new animation technology which makes her synchronized eye and mouth movements life-like. She recognizes and reacts to voice and changes in light, temperature and motion with over 100 discrete synthesized speech responses stored in her resident memory. She also has a sensor in her hand to

identify words and pictures in her own stickerbooks. JULIE's vocabulary is expandable with accessory 64K voice cards and stickerbooks.

LITTLE BOPPERS is a line of seven 12-inch plush characters: TEDDY RUXPIN, MICKEY MOUSE, MINNIE MOUSE, DONALD DUCK, GOOFY, MISS PIGGY and KERMIT. Activated by clapping hands, music or other sounds, the characters move their arms and legs as if they're dancing.

THE MAGICAL COMES TO LIFE Books fit into a frame which has a membrane touch sensor keyboard and is programmed with 128K of computer memory. As each page of the book is turned, music or a background sound effect appropriate for the setting is heard. In addition, when pressed, certain pictures and words on each page trigger specific sounds. The frame is accompanied with a "Let's Go . . . to the Farm" storybook, featuring THE TALKING MOTHER GOOSE and HECTOR characters. Four additional storybooks and memory cartridges in THE TALKING MOTHER GOOSE and HECTOR series and four in a MUPPET BABIES series are available separately.

OVER THE EDGE is an electronic game consisting of a small hexagonal "puck" which players shuffle across a game mat. The puck registers points automatically when it glides over the scoring lines on the mat. Scores are digitally recorded for each point.

CALL MY BLUFF is an electronic board game with built-in audio cassette player. Simulating a television game show, the game matches the intellectual skills of up to six players on a variety of subjects, including sports,

history, music and general interest. Separate cassettes with expanded questions and subjects are also available.

G.I. JOE LAZER BATTLE combines the G.I. Joe character with the LAZER TAG game. The set contains a futuristic gun, a target which can be worn by an opponent and a belt. The guns and targets are compatible with LAZER TAG STARLYTES and sensors.

Video Products

At the 1987 Toy Fair, the Company announced in its first video product line, which it expects to ship to retailers commencing in the summer of 1987. ACTION MAX is an interactive game system which connects to a videocassette recorder. Players use a game pistol to "hit" flashing targets that appear on the television screen, and points are accumulated based on speed and frequency of hits. The Company is currently engaging in the development of other interactive audio/video products. See "Product Design and Development – Internal Development."

School Accessories

In February 1987, the Company announced its first line of school accessories at the Back-to-School Show. The CLASS ACT line of "fashion" school supplies is targeted at the teenage market and consists of both electronic and non-electronic items, including STUFF-IT, a fully-enclosed molded plastic binder; SACK-IT, a line of stone-

bleached denim backpacks and totes; RACK-IT, an adjustable locker divider and EXPRESS-IT, a locker message machine.

The market for school supplies is highly seasonal, with a majority of retail sales occurring in August and September. The Company has commenced the manufacture of certain of its school accessories and expects initial shipments of these products to retailers in June and July in time for the back-to-school selling season. However, the timing of retail availability may be affected by accelerations or delays in the production cycle in the normal course of business, as well as decisions regarding the method of shipment of products from manufacturing facilities in the Far East and other locations.

Pre-School Toys

The Company expanded into pre-school toys through an agreement to acquire Greybridge in December 1986. See "Product Design and Development – Other Independent Designers and Consultants." Greybridge's IMAGINACTION product group includes: SQUEEZINGTON SQUARE playhouses and playstores made from colorful quilted fabric, complete with "bean bag" people and furniture: CREATIVITY WALL, a creativity center/easel that mounts on the wall or is freestanding and comes with drawing materials, patterns and storage boxes; and BLOCK SENSATIONS, transparent plastic cubes containing objects designed to stimulate toddlers' senses.

Licensing Revenue

The Company has a number of licensing agreements under which third parties manufacture and distribute merchandising and promotional goods (including clothing for children, linens and novelty items) depicting THE WORLD OF TEDDY RUXPIN and LAZER TAG. The Company receives royalties based on sales of these products, although payments to date have not been substantial. Generally, these agreements have terms of two years, provide for initial cash payments to the Company as nonrefundable advances against royalties, and require certain minimum annual royalty payments. Licensing revenues from TEDDY RUXPIN are divided equally between the Company and Alchemy, after reimbursement to the Company for costs incurred in generating such revenues and after payment of 10% of the resulting net revenues to Ken Forsse, the chief executive officer and the principal shareholder of Alchemy.

Product Development and Design

The Company's product development strategy encompasses the use of independent designers, character and technology licenses and internal development. The Company also periodically evaluates the prospects of acquiring or participating in joint ventures with other companies which are developing products compatible with the Company's product strategy. To date the Company's product development and design activities have principally been derived from the following sources:

Alchemy

THE WORLD OF TEDDY RUXPIN and the related talking toy technology were developed by Alchemy, a privately-owned design and production company based in Chatsworth, California. Under a Development and Marketing Agreement (the "Agreement") with Alchemy, the Company acquired exclusive worldwide manufacturing and distribution rights to the talking toy technology and the characters in THE WORLD OF TEDDY RUXPIN. The talking toy technology is the subject matter of two pending patent applications which have been filed worldwide, and the characters in THE WORLD OF TEDDY RUXPIN are the subject of existing copyrights, trademarks and design patents which have been filed worldwide. Alchemy receives royalties on sales from articles using the talking toy technology and from products using THE WORLD OF TEDDY RUXPIN characters. The Agreement also provides the Company with a right of first refusal to manufacture, market and distribute any other products targeted for the retail market, developed or to be developed by Alchemy during the term of the Agreement. The Agreement is effective through December 1995, with an option by the Company to renew for an additional 10 years.

The Company accrued royalty expenses to Alchemy of approximately $5.8 million and $13.3 million for the years ended March 31, 1986 and 1987, of which approximately $8.8 million was payable at March 31, 1987. During fiscal 1986 and 1987, the Company paid Alchemy $900,000 and $700,000, respectively, for the production of story cassette tapes and the development of specified products. Although the Company is no longer required to

advance development costs to Alchemy under the Agreement, the Company expects to continue to use Alchemy to develop story cassette tapes and other concepts or products and to make applicable advances. See Note 2 of Notes to Consolidated Financial Statements.

While the Company created the concept for THE TALKING MOTHER GOOSE, Alchemy played a substantial role in the refinement of the concept and the development of the prototype. As a result, the Company has agreed to pay Alchemy a character royalty, as well as the talking toy technology royalty, on the sale of the product, related characters and accessories. Alchemy created the concept for the HECTOR character that accompanies THE TALKING MOTHER GOOSE and owns the copyright and trademark for this character. The Company has contracted with Alchemy to develop the story cassette tapes for THE TALKING MOTHER GOOSE in exchange for royalty payments. Although Alchemy is not creating the story cassette tapes for the PEANUTS and Disney products, Alchemy will also receive talking toy technology license fees on the sale of the PEANUTS and Disney character products and accessory tapes.

The Company's relationship with Alchemy previously involved a number of disputes. In December 1986 the Company and Alchemy amended the Agreement to resolve all outstanding disputes. The resolution of these disputes did not and will not have a material adverse impact on the operations of the Company. In conjunction with the settlement, the Company loaned Alchemy $2.0 million in connection with Alchemy's repurchase of a minority stockholder's interest in Alchemy. As a condition of the repurchase, the minority stockholder agreed to

withdraw two actions filed against Alchemy, the Company and Donald Kingsborough, Chairman of the Board and Chief Executive Officer of the Company. The loan to Alchemy is repayable over seven years and collateralized by all assets of Alchemy including royalties due Alchemy by the Company. The loan is interest-free for the first two years and bears interest thereafter at a rate equal to the Company's average borrowing rate, subject to quarterly adjustments as this rate changes.

Other Independent Designers and Third-Party Contractors

The Company has acquired or licensed from other independent designers a number of product design and/or technology rights, including the rights to the CALL MY BLUFF and ACTION MAX product lines, and the LITTLE BOPPERS and THE MAGICAL COMES TO LIFE technologies. Depending on its arrangement with the designer, the Company acquires either distribution rights or ownership of the product design or technology. Generally, these arrangements require the Company to make an initial payment and subsequent royalty or royalty-type payments on net sales of the new products or products utilizing the technology.

The CLASS ACT school accessories line was developed by a partnership whose partners consist of an officer of the Company and a major vendor to the Company. See "Management – Certain Transactions." Under an exclusive option and license agreement with the partnership, the Company acquired worldwide manufacturing and distribution rights to the product line in exchange for royalties based on sales of the products. The agreement is

for an initial term ending August 31, 1991 and grants the Company a five-year renewal option if the Company meets certain royalty levels.

The Company also has arrangements with several independent contractors to assist in the design and development of portions of new products and accessories, artwork and graphics, packaging and television production. These contractors are generally paid on a project basis, and the results of their efforts become the property of the Company. The Company believes that the use of independent contractors provides a valuable, cost-effective means of supplementing internal resources and intends to continue utilizing such services.

Character Licenses

The Company's product lines have also been expanded through the adaptation of product ideas and technologies to existing well-known characters. Under a sublicense agreement, the Company acquired from United Features Syndicate and Determined Productions the exclusive worldwide rights, except in Brazil, to manufacture and sell electromechanical plush versions of characters from the PEANUTS comic strip in exchange for royalties based upon net sales. The term of the agreement expires on December 31, 1987, and will be automatically renewed for subsequent periods through June 30, 1990 provided the Company achieves certain sales levels of the PEANUTS characters and related accessories.

Under license agreements with The Walt Disney Company ("Disney") and Disneyland-Vista Records, the Company acquired the exclusive right to manufacture and sell in the United States mechanical talking plush toys using certain Disney characters as well as audio cassette tapes and storybooks for use with such toys and related accessories in exchange for royalties. The license agreements are for an initial term ending October 31, 1987 and grant the Company three consecutive one-year renewal options subject to certain conditions being met. In January 1987, the Company and Disney agreed to expand the geographical territory of the mechanical talking plush toy license to include other countries of the world. In addition, Disney agreed to permit the Company to use the Disney characters in connection with worldwide sales of the Company's LITTLE BOPPERS and THE MAGICAL COMES TO LIFE product lines. It was also agreed that Disney license to the Company the right to use the WINNIE THE POOH characters in several product lines.

The Company entered into a license agreement with Henson Associates, Inc. in June 1986 and amended the license agreement in January 1987. The agreement, as amended, grants the Company exclusive rights to manufacture and sell in the United States and Canada certain toys, pre-school toys and related ancillary products using JIM HENSON MUPPET, MUPPET BABIES and FRAGGLE ROCK characters in exchange for royalties based on net sales. The agreement, as amended, expires December 31, 1991.

Under a license agreement entered into in December 1986 between the Company and Hasbro, Inc., the

Company has the exclusive right to manufacture and sell in the United States and Canada infrared lazer guns, targets and accessories using the G.I. JOE character in exchange for royalties based on net sales. The agreement is for an initial term ending December 31, 1991 and grants the Company a three-year renewal option if the Company meets certain royalty levels.

Internal Development

Internal product design and development is a joint effort between the Company's marketing and engineering groups. The Company spends considerable time and effort in concept development, product design and research. In addition, the Company pre-tests product concepts and prototypes through consumer market research techniques, including focus groups and in-home use tests. All such research is conducted by independent third parties.

To date the Company has internally created and developed the LAZER TAG, PAMELA, JULIE and OVER THE EDGE product lines and created the concept for THE TALKING MOTHER GOOSE and THE MAGICAL COMES TO LIFE Books. In fiscal 1986 and 1987, the Company incurred $1.4 million and $6.2 million, respectively, of product development expenses.

The IMAGINACTION product lines were developed by Greybridge, a company which develops and markets toys primarily for the pre-school market. The Company acquired all the stock of Greybridge under an agreement reached in December 1986 and will continue to market

existing products and new products under Greybridge's IMAGINACTION name.

The Company continually explores opportunities to adapt technologies to innovative entertainment and leisure products that can be promoted and distributed through mass market channels. In April 1986, the Company acquired for cash the assets of Intraview Systems Corporation, a privately-held corporation which was engaged in the development of interactive audio/video products. The Company is currently engaged in the ongoing development of these products.

Marketing and Sales

The Company's products are sold throughout the United States by independent manufacturers' representatives who are compensated on a commission basis and by Company sales personnel. The products are sold to toy stores, toy distributors, catalog showrooms, mass merchants, department stores and discount stores. Toys "R" Us, Inc., the largest toy store chain in the United States, was the Company's largest customer in fiscal 1986 accounting for approximately 16% of the Company's net sales. During fiscal 1987, Toys "R" Us, Inc. and Kmart Corporation accounted for approximately 19% and 13%, respectively, of the Company's net sales. While no other customer accounted for more than 10% of net sales in such periods, a limited number of customers have accounted for and continue to account for a significant percentage of the Company's net sales.

The Company sells its products internationally through WOW International, Ltd., one of its Hong Kong-

based subsidiaries, to distributors in various foreign markets. Under territorial distributorship agreements, certain of the Company's products are distributed by Charan Industries in Canada; by Mattel, Inc. in Western Europe, Australia, New Zealand, Singapore and Malaysia; by Tsukuda Original Co., Ltd. in Japan; and by Kong King in Hong Kong. The distributorship agreements commit the distributors to minimum annual purchase quantities. Mattel has agreed during the term of its distributorship agreement not to sell toys in its territories which compete with the product lines it distributes for the Company. In addition, Mattel has the first opportunity to negotiate for distribution rights for new products and new territories for which the Company may grant foreign distribution rights. During fiscal 1986 and 1987, international shipments pursuant to these distributorship arrangements were less than 10% of total net sales.

The Company's product lines require a relatively high level of promotion in order to attain consumer recognition and commercial success. Promotional efforts are oriented toward the retail trade and adults, as well as toward children. The Company's promotional strategy utilizes advertising, television programming, public relations, point-of-purchase displays and cross promotions.

The Company advertises its product lines extensively on television and, in accordance with general industry practice, offers customers advertising incentives in order to promote the Company's products on television and in print.

Product advertising is augmented with the production of television specials and/or series featuring the

Company's products. Three such productions have been made to date. In the fall of 1985, two 30-minute animated television specials featuring THE WORLD OF TEDDY RUXPIN were aired. In a joint production with Alchemy, another series consisting of 65 animated episodes of the ADVENTURES OF TEDDY RUXPIN is in progress. Distributed by Lexington Broadcast System, five were broadcast in a mini-series in March 1987, and all 65 episodes are expected to be broadcast weekdays for a period of 13 weeks in the fall of 1987. In addition, a series of 13 animated programs based on LAZER TAG was aired every Saturday on the NBC television network from September through December 1986.

Talking and/or animated point-of-purchase displays are also an important element of the Company's marketing program. The displays are generally three to four feet long and are placed at the end of an aisle of toys or on a retailer's shelf. When a customer activates a display unit, he hears a three to four minute description of the product and can see the product functioning.

During the years ended March 31, 1986 and 1987, the Company incurred costs of $9.7 million and $46.4 million, respectively, for television advertising, cooperative advertising with retailers, public relations and point-of-purchase displays.

The Company believes that gauging customer demand is critical to its long-term success. To assist in this, the Company has a National Merchandising Program designed to put merchandising representatives (of which some are employed by a subsidiary of the Company and some are retained on a part-time contract basis)

in direct field contact with retailers to increase the Company's access to "sell-through" information. In addition to monitoring inventory levels at selected outlets, the merchandisers service and repair the Company's point-of-purchase displays, participate in product promotions, and monitor and enhance the Company's presence at the retail level.

The Company is the master sales representative in the United States for Nintendo of America, Inc.'s Nintendo Entertainment System. The Company uses its manufacturers' representative organization and its direct sales personnel to sell Nintendo's products, for which it receives a commission based on net sales. The Agreement with Nintendo is terminable by either party with 90 days written notice.

Seasonality and Backlog

The demand for toys is highly seasonal with a majority of toy retail sales taking place during the Christmas season. Toy Fair and major regional toy shows generally occur in January and February each year. The Company receives orders early in the year for products that are generally not scheduled for delivery until late in the year and for which there is not yet any significant public demand. The demand for school accessories is also highly seasonal with a majority of retail sales taking place during the fall back-to-school season. Retailers generally may cancel without penalty all or part of the orders for toys or school accessories prior to shipment. Therefore, the Company generally will not build to such orders until consumer demand for the products is demonstrated. Due to

the ability of retailers to cancel orders without penalty, the Company believes its order backlog at any point in time may not be indicative of actual sales for any succeeding period.

Manufacturing

Manufacturing Strategy

The Company's present strategy is to contract for all its manufacturing requirements, primarily through its wholly-owned Hong Kong subsidiary, Sourcing International Limited ("SIL"). SIL also sources raw materials and components and provides engineering, quality control and quality assurance support. SIL was acquired by the Company in February 1986. Prior to that, SIL provided certain of these services to the Company on a fee basis.

The Company's toys are presently manufactured to its specifications by unaffiliated contract manufacturers who have facilities in Hong Kong, the People's Republic of China, Taiwan, Korea, Thailand and the United States. During fiscal 1986, three manufacturers accounted for 95% of the TEDDY RUXPIN units produced, representing 63% of net sales. To meet its manufacturing requirements for fiscal 1987 and to avoid increasing its dependence on its existing manufacturers, the Company used a greater number of contract manufacturers to produce TEDDY RUXPIN, LAZER TAG and the Company's other products. However, a limited number of manufacturers continue to account for a significant percentage of the Company's production needs.

Decisions related to the choice of manufacturer are based on price, product quality, reliability and the ability of a manufacturer to meet the Company's delivery requirements. Manufacturing contracts generally have a one-year term and provide for delivery of finished products based upon rolling 90-day production schedules provided by the Company, composed of non-cancellable orders for the first 30-day period, non-cancellable but reschedulable orders for the next 30-day period and a cancellable estimate of needs for the last 30-day period. The Company may terminate the contract upon 60 days' notice to the manufacturer. These terms allow the Company to reduce production volumes with relatively short notice to reflect decreases in demand.

Management believes that its strategy to contract for all manufacturing requirements provides the Company with financial flexibility and the most efficient use of its capital. However, since the Company does not have its own manufacturing facilities, it is dependent on close working relationships with its contract manufacturers for the supply and quality of its products. See "Risk Factors – Dependence on Foreign Contract Manufacturers."

Transportation

The Company depends on sea and air transport. As a result, it may be subject to labor disruptions, particularly in the maritime shipping industry, and to limitations on the availability of air cargo space during certain periods of the year. To date, the Company has not been materially affected by any such disruptions or constraints. Although air cargo is significantly more expensive than sea cargo,

the Company has used and expects to continue to use air cargo to meet higher than anticipated seasonal demand or to mitigate production delays for particular products. Cargo management, importation and distribution services are provided by Sears World Trade, Inc. under an import services agreement which expires June 30, 1987. Sears World Trade, Inc. has notified the Company that it is leaving the cargo management, importation and distribution services business, but intends to fulfill its obligations under the present agreement through its expiration date. The Company has begun to, and intends to continue to, arrange for the shipping, importation and distribution of its own products.

Molds and Components

The Company contracts the design and fabrication of all its molds, primarily with companies in Hong Kong, the United States and Taiwan. The completed molds, which remain the property of the Company, are then consigned to designated manufacturers. A large percentage of the Company's fiscal 1987 mold requirements were fulfilled by one manufacturer, in which the Company acquired a 20% interest in July 1986.

The principal materials used in the production and sale of the Company's products are plastics, synthetic fabrics, paper products and electrical, mechanical and electronic components. With the exception of certain electronic components, the Company believes that an adequate supply of materials used in the manufacture of its products is readily available from existing and alternate sources and at reasonable prices.

In some cases, integrated circuits incorporated in certain of the Company's products are available only from single sources. The Company has arranged for the sole suppliers of the integrated circuits to carry additional inventories. However, if the Company is not able to obtain any of these components in sufficient quantities, the results of its operations may be adversely affected.

Quality Control and Assurance

The Company maintains a quality control and quality assurance program. The Company has identified certain components in its products which its contract manufacturers are allowed to purchase only from designated approved suppliers. Each contract manufacturer submits samples from early production runs to independent testing laboratories to determine whether the manufacturer is producing to certified safety and product standards. On an ongoing basis, random samples are drawn from each manufacturer for full-scale testing.

The Company has established inspection and test criteria for each of its products. These test criteria are applied by the Company regularly to product samples in each manufacturing location prior to shipment. Once the products arrive in the United States, samples are subject to another inspection prior to distribution.

Information Systems and Control Procedures

The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and

control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures and controls to meet the demands of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with the growth.

Product Warranty

Most of the Company's current products carry a 90-day replace-or-repair warranty for sales in the United States. On international sales, warranty periods vary by country according to law or custom, and warranty costs are shared between the Company and its distributors.

The Company's products include many complex toys which can experience relatively high return rates. The Company excludes actual and estimated returns from reported net sales. The Company continues to develop and market complex toys and other products, and there can be no assurance that products will not experience high return rates or warranty problems in the future.

Legal Proceedings

On July 18, 1986, an action was filed against Alchemy and the Company in the United States District Court for the Central District of California by Charles E. Kowalski, claiming an interest in past and future royalties paid to Alchemy in connection with sales of TEDDY RUXPIN and alleging violations of the Lanham Act as a result of the Company's use of the words "exclusive manufacturer and distributor" in connection with the Company's sales

of TEDDY RUXPIN. The Company has an indemnification agreement with Alchemy covering Kowalski's claims. Although the outcome of any litigation is uncertain, the Company believes Kowalski will not recover any material amounts for which the Company cannot receive reimbursement from Alchemy.

On August 27, 1986, First Delta Group, Inc. filed an action against the Company in the United States District Court for the Northern District of Illinois alleging wrongful termination of First Delta Group's arrangement as a manufacturers' representative for the Company. Although the outcome of any litigation is uncertain, the Company believes the claim is without merit and that resolution of this matter will not have a material adverse effect on the Company.

On February 11, 1987, Harold Manglesen & Sons, Inc. ("Manglesen") filed an action in the United States District Court for the District of Nebraska alleging trademark infringement as a result of the Company's use of the words "The Living Doll" in connection with the Company's sales of PAMELA. Manglesen seeks both damages and equitable relief. Discovery has recently commenced. Although the outcome of the litigation is uncertain, the Company believes that the resolution of this matter will not have a material adverse effect on the Company.

On March 24, 1987, an action was filed against Alchemy and the Company in the United States District Court for the Central District of California by Ronald W. Burnett, alleging damages for fraud and conspiracy to defraud, negligent misrepresentation, breach of fiduciary

duty, breach of contract, conversion, bad faith, constructive trust, accounting, declaratory relief and violations of the Lanham Act as a result of the Company's use of the words "exclusive manufacturer and distributor" in connection with the Company's sales of TEDDY RUXPIN. The Company has filed a motion to dismiss the complaint. Discovery has recently commenced. The Company has an indemnification agreement with Alchemy covering all of Burnett's claims except for fraud. Although the outcome of any litigation is uncertain, the Company believes Burnett will not recover any material amounts for which the Company cannot receive reimbursement from Alchemy.

Competition

The toy industry is highly fragmented with over 700 domestic toy companies and over 85 product categories as defined by the Toy Manufacturers of America, an industry trade group. No one competitor accounts for more than 11% of domestic industry sales. The industry is, however, influenced by five major firms – Hasbro, Inc.; Mattel, Inc.; Coleco Industries, Inc.; Fisher-Price; and Kenner Parker Toys, Inc. Together, they accounted for approximately 32% of 1986 toy sales in the United States. Virtually all competitors select several categories in which to compete, and no competitor offers products in every category.

The Company believes it has the largest share of the animated talking toy market. As happens with any successful toy, however, a number of competitive animated

toys were introduced for the 1986 Christmas season by Hasbro, Inc., Axlon, Inc., View-Master Ideal Group, Inc. and others. The introduction of these competitive products has resulted in a decreased market share for the Company within this market segment. This competition may also result in reduced gross margin due to price pressure.

The Company's LAZER TAG line faces direct competition from other similar futuristic toys, such as L.J.N. Toys, Ltd.'s Photon. The PAMELA line faces competition from other talking dolls, such as Playmates Inc.'s Cricket and Lewis Galoob Toys, Inc.'s Baby Talk, as well as from nontalking dolls marketed by the Company's competitors.

With respect to any new toy, video product, school accessory and pre-school toy, the Company may compete with several larger and many smaller domestic and foreign manufacturers, importers and distributors, some of which have greater assets and resources than the Company. Furthermore, new competitors may enter the markets with relative ease. Product innovation, quality, product identity through marketing and promotion, and strong distribution capabilities are all important elements of competition in these industries. The Company believes that it compares favorably with other companies on these factors.

Government Regulation

The Company is subject to the provisions of the Federal Hazardous Substances Act and the Federal Consumer Product Safety Act. Those laws empower the

Consumer Product Safety Commission (the "CPSC") to protect children from hazardous toys and other articles. The CPSC has the authority to exclude from the market articles which are found to be hazardous and can require a manufacturer to repurchase such toys under certain circumstances. In the pre-production stages and periodically thereafter, the Company causes sample toys to be sent to independent laboratories to test for compliance with the CPSC's Rules and Regulations, as well as with the voluntary product standards of the Toy Manufacturers of America. Similar laws exist in some jurisdictions in the United States as well as in certain foreign countries. To date, the Company has not experienced any material safety or governmental compliance problems with respect to its products.

Certain of the Company's products are subject to Federal Communications Commission ("FCC") regulations which establish radio frequency mission standards for radio transmitters and computing equipment. Sales in the United States of products which fail to comply with the specification may be prohibited by the FCC until appropriate modifications are made. The Company monitors its products for FCC compliance both in Fremont, California and in Hong Kong.

The United States Government has established a Generalized System of Preferences which affords duty-free status to certain of the Company's products that are imported into the United States. The United States Government reviews the Generalized System of Preferences on a periodic basis to determine whether specific commodities imported from certain countries should continue

to receive duty-free status. Factors taken into consideration include the countries' level of economic development as well as their share of the commodities' worldwide volume. Future reviews could result in the loss of duty-free benefits on Company products which are currently imported duty free. The loss of such benefits, to the extent they are not offset by price increases, could have a negative impact on the Company.

Licenses, Patents, Trademarks and Copyrights

A majority of the Company's sales to date have been derived from products under patent, know-how, trademark and copyright licenses from third parties. The Company anticipates that a significant portion of future revenues will continue to be derived from licensed product lines. See "Product Development and Design."

The Company generally attempts to obtain patent, trademark or copyright protection on products not covered by licenses with others. The Company owns or is the licensee of other patents or applications for many United States and foreign patents, copyrights and trademarks covering proprietary products as well as mechanisms used in both licensed and proprietary products.

The Company believes that its license rights, patents, trademarks and copyrights are of significant value, and the loss of these rights for particular products or product lines might have a material adverse effect on the Company's business. It is the Company's policy to defend vigorously its license rights, patents, trademarks and copyrights against infringement, and the Company is prepared to undertake litigation, if necessary, to assert its

rights to them. Except as described in "Legal Proceedings," the Company is not aware of any pending challenges to the validity of its or its licensors' patent, trademark and copyright rights, as practiced by the Company.

Based upon the success of the Company's products, it anticipates the introduction of look-alike products and accessories which it believes may infringe applicable copyrights, trademarks and patents. The Company intends to prosecute vigorously such infringers. In two instances the Company has obtained injunctions against firms it believes were infringing the Company's story tapes. The Company also believes that its relationships with its contract manufacturers in Hong Kong, Taiwan and Korea and with distributors in Hong Kong and Japan discourage the production of foreign look-alike products by manufacturers in such countries and facilitates the detection of such illegal foreign manufacturing. The Company also works with United States customs officials to prevent the importation of illegal look-alike products.

Facilities

The Company's principal executive offices are located in Fremont, California, where it occupies 140,000 square feet of office and engineering space and 60,000 square feet of warehouse space in four adjacent buildings. These facilities are leased under four separate leases which expire from April 1990 to February 1991 and are renewable for additional five-year periods. The Company leases approximately 310,000 square feet of warehouse space and approximately 65,000 square feet of additional

office and customer service space in four buildings located in Milpitas, California on short-term leases which expire through April 1988. The Company has recently entered into a lease through March 1988 for approximately 385,000 square feet of warehouse space in Hayward, California to fulfill additional space needs as well as to replace two of the existing warehouses that are under leases which soon expire. The Company's need for warehouse space is seasonal and, while the Company currently has sufficient facilities, it may require additional space later in the year. The Company does not anticipate difficulty in acquiring such space.

The Company also leases 6,000 square feet of office space in Hong Kong under a three-year lease expiring April 1989. The Company believes its facilities in Hong Kong will not be adequate for its future business needs and is currently seeking additional facilities.

See Note 8 of Notes to Consolidated Financial Statements for information regarding the Company's obligations under leases.

Employees

At March 31, 1987, the Company had 441 full-time employees composed of 34 in sales, 49 in marketing, 240 in manufacturing and engineering, 55 in operations administration, and 63 in financial and corporate administrative activities. Of such employees, 116 were located in Hong Kong, Taiwan and Korea. The Company also utilizes a significant number of temporary employees in

the United States, which number varies according to seasonal needs. The Company anticipates hiring a substantial number of additional employees in all areas during the next year. There can be no assurance, however, that the Company will be able to attract and retain qualified personnel in sufficient numbers to meet its needs. None of the Company's employees is covered by a collective bargaining agreement. The Company considers its employee relations to be good.

MANAGEMENT

Executive Officers and Directors

The executive officers and directors of the Company are as follows:

Name	Age	Title
Donald D. Kingsborough. . . .	40	Chairman of the Board and Chief Executive Officer
Angelo M. Pezzani	45	President, Chief Operating Officer and Director
Mark Bradlee.	38	Executive Vice President – Sales
Dennis B. Donahue	48	Executive Vice President – Manufacturing
M. Robert Goldberg	39	Executive Vice President – Marketing
William F.X. Grubb.	42	Executive Vice President and General Manager – School Accessories Division
Larry C. Lynch	48	Executive Vice President – Engineering
Richard B. Stein . . .	51	Executive Vice President and Chief Financial Officer

Brian M. Wong	33	Executive Vice President – Administration
John B. Howenstine	46	Director
Barry H. Margolis	41	Director

Donald D. Kingsborough is the principal founder of the Company and has served as Chairman of the Board and Chief Executive Officer since the Company's inception. Prior to founding the Company, Mr. Kingsborough consulted with various companies from 1984 to 1985. From 1983 to 1984, he was Executive Vice President, Sales and Marketing and a Division President of Atari, Inc., which was at the time a video game and computer manufacturer. Mr. Kingsborough founded Software Knowledge Unlimited, Inc., a national distributor of software and peripherals for personal computers, where he served as President and Chief Executive Officer from 1982 to 1983. From 1976 to 1983, he was President and Chief Executive Officer of DK Marketing, an electronics manufacturers' representative firm.

Angelo M. Pezzani joined the Company in May 1985 as Executive Vice President-Legal and was named Chief Operating Officer in February 1986 and President in April 1987. Mr. Pezzani performed consulting services for various start-up companies from 1984 to 1985. From 1982 to 1984, Mr. Pezzani was Vice President-Divisional General Counsel of Atari, Inc., providing legal counsel on technology licensing, trademarks and copyrights, domestic and international joint ventures and general corporate legal matters, as well as managing outside legal support. From

1973 to 1982, Mr. Pezzani was Vice President-Law, Associate General Counsel and Assistant Secretary of Chromalloy American Corp. in St. Louis, Missouri, a publicly-traded multinational company.

Mark Bradlee has served as Executive Vice President-Sales since the Company's inception. Prior to joining the Company, Mr. Bradlee co-founded National Sales Group, a manufacturers' representative organization for the distribution of home microcomputer software packages, where he served as President from 1984 until National Sales Group was purchased by the Company (see "Certain Transactions"). Mr. Bradlee founded and was Vice President of Sales for Flagship Software Systems of Santa Clara, California, a software distributor, from 1983 to 1984. From 1981 to 1983, he served as Vice President of Sales for Imagic, Inc., a video game manufacturer which he co-founded.

Dennis B. Donahue joined the Company as Vice President-Manufacturing in May 1986 and was named Executive Vice President-Manufacturing in April 1987. From 1984 to 1986, Mr. Donahue was Vice President of Operations for the Lexar Division of United Technologies Communications Co. in Westlake Village, California. From 1982 to 1984, he served as Vice President of Manufacturing for the Consumer Products Division of Atari, Inc.

M. Robert Goldberg joined the Company as Executive Vice President-Marketing in December 1985. Prior to joining the Company, Mr. Goldberg was President of The Learning Company, a computer software publisher. From 1984 to 1985, Mr. Goldberg was with Software Knowledge Unlimited, Inc., a computer software distributor, as Vice

President of Marketing responsible for all purchasing, merchandising, advertising and product development. From 1972 to 1983, Mr. Goldberg was employed by CBS Specialty Stores as Director of Computer Speciality Stores.

William F.X. Grubb joined the Company as Executive Vice President and General Manager – School Accessories Division in October 1986. Prior to joining the Company, he shared the office of the President of Axlon, Inc. with Axlon's founder. Mr. Grubb was Executive Vice President for Dataspeed, a data communications company, from 1983 until Dataspeed was sold to Lotus Development Corporation in 1985. From 1981 to 1983, he served as Chief Executive Officer of Imagic, Inc., which he co-founded.

Larry C. Lynch joined the Company at its inception as Vice President – Manufacturing and Engineering. Mr. Lynch was named Executive Vice President – Manufacturing and Engineering in June 1985 and became Executive Vice President – Engineering in April 1987. From 1984 to 1985, Mr. Lynch was Product Development Director of Nellcor, Inc., a manufacturer of medical instrumentation. Mr. Lynch was Vice President of Operations Engineering – Consumer Products for Atari, Inc. from 1980 to 1984, and was responsible for test engineering, automation, industrial engineering, project management, licensee operations and manufacturing documentation.

Richard B. Stein joined the Company as Executive Vice President in June 1986 and became Chief Financial Officer in July 1986. From January 1985 to June 1986, Mr. Stein served as Senior Vice President and Chief Financial

Officer of Shaklee Corporation, a manufacturer of nutritional, personal care and household products. Prior to that, Mr. Stein was with Esselte Business Systems, Inc., a large multi-national office supplies, graphic arts supplies, and retail systems and equipment company, where he served as Senior Vice President and Chief Financial Officer from July 1979 to August 1984.

Brian M. Wong has served as Executive Vice President – Administration for the Company since its inception. From 1981 to 1985, he was with Atari, Inc., serving in several positions, including Director of Operations, Director of Sales Planning and Director of Supply and Demand.

John B. Howenstine has served as a director of the Company since its inception. In 1976 he joined J.S. Abercrombie Interests, Inc. and was the President of J.S. Abercrombie Mineral Company from 1983 until December 1986. In January 1987, he became President of Josephine E. Abercrombie Interests, Inc. In addition, he serves as an officer and representative for various other Abercrombie entities and investments, several of which are principal shareholders of the Company. See "Principal Shareholders."

Barry H. Margolis has served as a director of the Company since August 1985. Since 1977, he has been the Managing Partner of Margolis, Phipps & Co., a public accounting firm in Houston. Mr. Margolis is the Managing Partner of W.O.W. Shares Partnership, a principal shareholder of the Company. See "Principal Shareholders." Mr. Margolis also currently serves as a director of Allied Bank of Texas in Houston.

Directors of the Company are elected to one-year terms and serve until their successors are duly elected and qualified. Mr. Kingsborough is entitled to be appointed a director during the term of his employment agreement. See "Executive Compensation." Officers serve at the discretion of the Board of Directors. The Board of Directors intends to expand the Board with additional outside members.

Executive Compensation

The following table sets forth the cash compensation of each of the Company's five most highly compensated executive officers whose cash compensation exceeded $60,000, and the aggregate cash compensation of all executive officers as a group, for the fiscal year ended March 31, 1987.

Name of Individual	Capacities in Which Served	Cash Compensation (1)
Donald D. Kingsborough	Chairman of the Board and Chief Executive Officer	$ 422,308
Angelo M. Pezzani	President, Chief Operating Officer, Director and Secretary	212,967
Richard B. Stein	Executive Vice President and Chief Financial Officer	166,800
Mark Bradlee	Executive Vice President – Sales	142,981
Larry C. Lynch	Executive Vice President – Engineering	142,924

All executive officers as a group
(10 persons) (2) $1,664,626

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(1) The Company has no pension, retirement, annuity, savings or similar benefit plan.

(2) Includes compensation paid to Messrs. Don L. Hawley and Stephen M. Race, who resigned as Executive Vice Presidents of the Company on April 1, 1987. Excludes compensation paid to Mr. Dennis B. Donahue, who was elected Executive Vice President – Manufacturing on April 1, 1987.

On March 1, 1986, the Company entered into five-year employment agreements with Donald Kingsborough and Angelo Pezzani, officers and directors of the Company. The agreements provide for initial annual salaries of $400,000 and $200,000, respectively, and subsequent salary increases of at least 10% annually. In the event they die or become permanently disabled, they (or their heirs or assigns) shall be entitled to receive their then current salaries over the remainder of the term of the agreement. In the event they are terminated without cause, the Company is obligated to pay in a lump sum an amount equal to the greater of two years' salary or the amount due for the balance of the employment term. If the Company is acquired or substantially alters its principal line of business, they shall be entitled to terminate their employment and shall be paid an amount equal to one year's salary. If the Company fails to elect Mr. Kingsborough as Chief Executive Officer and Chairman of the Board or fails to elect Mr. Pezzani as President, they shall be entitled to terminate their employment and shall be paid in a lump sum an amount equal to the salary payments which

would have been paid for the remainder of the employment terms. Pursuant to these agreements, the Company has purchased five-year term life insurance policies in the face amount of $1.0 million for each of Messrs. Kingsborough and Pezzani, and has given them the right to designate the beneficiary of any proceeds thereof. The Company pays all state and federal income taxes attributable to the premiums paid by the Company for such insurance policies. In addition, the Company maintains an insurance policy on the life of Mr. Kingsborough, the proceeds of which are payable to the Company.

On June 16, 1986, the Company entered into an employment agreement with Richard Stein. The agreement provides for an initial annual salary of $195,000 and options to acquire 210,000 shares under the Company's 1985 Incentive Stock Option Plan, at a price of $10.00 per share with respect to 90,000 shares and at a price of $18.00 with respect to the remaining 120,000 shares. In the event he is terminated involuntarily and without fraud against the Company (including termination as a result of death, disability or change in control), the Company is obligated to pay an amount equal to one year's salary if such termination occurs during the first two years, or six months' salary if such termination occurs thereafter. Pursuant to the agreement, the Company has purchased a five-year term life insurance policy in the face amount of $500,000 for Mr. Stein, and has given him the right to designate the beneficiary of any proceeds thereof. The Company pays all state and federal income taxes attributable to the premiums paid by the Company for such insurance policy.

The Company has executed employment agreements with terms ranging from two to four years with each of the other Executive Vice Presidents, providing for minimum base salaries, salary continuation for a period of six months in the event of illness or disability, and termination of employment only for cause as defined in the agreements. The Company pays all outside directors an annual fee of $25,000 payable in quarterly installments and reimburses them for their actual expenses incurred in attending meetings of the Board.

Employee Stock Plans

The Company's 1985 Incentive Stock Option Plan (the "Plan") was adopted by the Board of Directors in November 1985 and approved by the shareholders in December 1985, initially reserving 1,500,000 shares of Common Stock for issuance thereunder. In April 1986 the Board of Directors adopted, and the shareholders approved, an amendment to the Plan to increase the number of shares reserved thereunder to 2,000,000. In February 1987, the Board again amended the Plan in response to changes in federal tax law caused by the passage of the Tax Reform Act of 1986. The Plan provides for the grant to employees or consultants of either "incentive stock options" within the meaning of Section 422A of the Internal Revenue Code or nonstatutory stock options. As of April 30, 1987, options to purchase 1,710,867 shares of Common Stock at an average per share exercise price of $9.14 were outstanding, options for 150,883 shares had been exercised, and 138,250 shares remained available for future grant.

The Plan is presently administered by the Board of Directors and may in the future be administered by a committee appointed by the Board. The Board (or its committee) determines the terms of options granted under the Plan, including the exercise price, number of shares subject to the option, and the exercisability thereof. The exercise price of options granted under the Plan must be at least equal to the fair market value of the Common Stock on the date of grant, and the maximum term of each option may be no longer than 10 years. With respect to any participant who may own stock possessing more than 10% of the voting rights of the Company's outstanding capital stock, the exercise price of any incentive stock option must be at least equal to 110% of fair market value on the date of grant and the term may be no longer than five years. The aggregate fair market value of the Common Stock (determined at the date of the option grant) for which any employee may exercise incentive stock options in any calendar year may not exceed $100,000.

Of the executive officers named in the table under "Executive Compensation" above, at April 30, 1987 Mr. Kingsborough had been granted an option to purchase 49,500 shares at an exercise price of $2.56 per share, Mr. Pezzani had been granted options to purchase an aggregate of 150,000 shares at an average exercise price of $2.83 per share, Mr. Stein had been granted options to purchase 210,000 shares at an average exercise price of $14.57 per share, and Mr. Bradlee had been granted an option to purchase 30,000 shares at an exercise price of $3.33 per share. At April 30, 1987 executive officers as a group (8

persons) had been granted options to purchase an aggregate of 709,500 shares at an average exercise price of $8.29 per share, and options for an additional 1,152,250 shares had been granted to 128 individual employees. At April 30, 1987, none of the five individuals named in the "Executive Compensation" table had exercised options and only one executive officer had exercised an option for 10,000 shares at an exercise price of $1.67 per share. These shares were subsequently sold for $21.50 per share.

The Company intends to seek shareholder approval at the next annual meeting of shareholders to adopt a new stock option plan aggregating 750,000 shares, as well as a payroll deduction stock purchase plan aggregating 250,000 shares.

Certain Transactions

In March 1985, the Company issued 5,953,500 shares of Common Stock to Donald Kingsborough, Chairman of the Board and Chief Executive Officer of the Company, for consideration consisting of cancellation of indebtedness of the Company and cash aggregating $49,000 and the assignment to the Company of all of Mr. Kingsborough's rights, valued by the Board of Directors for accounting purposes at Mr. Kingsborough's approximate cost of $10,000, under the Development and Marketing Agreement with Alchemy, relating to technology and character rights for TEDDY RUXPIN. See "Business – Product Development and Design – Alchemy."

In April 1985, the Company issued 6,196,500 shares of Common Stock to John B. Howenstine, a director of the Company, as nominee for J.S. Abercrombie Interests, Inc.

("JSA") for $204,000 cash. Pursuant to a prior arrangement, in August 1985 the Company issued 1,620,000 shares of Common Stock to JSA in consideration of the arrangement by JSA of an irrevocable standby letter of credit in the amount of $9.0 million for use by the Company. For accounting purposes, the Board of Directors valued the letter of credit at $53,333, its cost to JSA.

In July 1985, Mr. Kingsborough and JSA converted loans to the Company into subordinated notes in the amounts of $151,000 and $3.5 million, respectively, bearing interest payable quarterly at the rate of 10% per annum or such greater rate as shall be necessary to avoid the imputation of interest by the Internal Revenue Service. The principal amount of the notes was payable upon the earlier of two years or the initial public offering by the Company. The notes were fully subordinated to all present and future bank debt of the Company, which was not to exceed $25 million unless approved by the Board of Directors. The notes were repaid in full in June 1986 from the proceeds of the Company's initial public offering.

Pursuant to agreements entered into in March, April and May 1985, the Company sold an aggregate of 1,408,500 shares of Common Stock in October 1985 at a per share cash price of $.10 to certain current executive officers and other employees pursuant to stock purchase agreements which provided the Company with an option to repurchase such shares at the original sales price in the event of termination of the shareholder's employment within a four year period from the date of the shareholder's initial employment. The Company's option terminated with respect to all of the shares upon the closing of the Company's initial public offering. In addition, the

agreements provided that, in the event of a proposed transfer of such shares, the Company would have the right to purchase such shares at the proposed transfer price less $.57 per share. This right also terminated upon the closing of the Company's initial public offering. Pursuant to these agreements, employees other than executive officers purchased an aggregate of 412,500 shares and executive officers purchased the following numbers of shares:

Name	Title	Number of Shares
Larry C. Lynch	Executive Vice President – Engineering	300,000
Mark Bradlee	Executive Vice President – Sales	300,000
Brian M. Wong	Executive Vice President – Administration	217,500
Angelo M. Pezzani	President and Chief Operating Officer	178,500

In October 1985, Mr. Kingsborough transferred 346,500 shares to Mr. Pezzani and 75,000 shares to Mr. Lynch at a per share price of $.10 pursuant to agreements which, in the event of a proposed transfer of such shares by Messrs. Pezzani or Lynch, provide Mr. Kingsborough the right to purchase such shares at the proposed transfer price less $1.13 per share.

In February 1986, the Company purchased the assets of National Sales Group ("NSG"), a manufacturers' representative for home microcomputer software, from Mr. Bradlee, an executive officer of the Company, and James Whims, a non-executive officer of the Company. Under the terms of the purchase agreement, the sellers received

cash of $20,000 and received 50% of the net profits from the continuing operations of NSG through March 31, 1987, which payments aggregated approximately $243,000. Management believes the terms of the purchase agreement were not less favorable to the Company than could have been realized by an arm's-length transaction with unaffiliated parties.

The Company has obtained various company insurance policies from various underwriters through insurance agencies with which Mr. Kingsborough's wife was affiliated as a sales agent. Mrs. Kingsborough received compensation for insurance policies written by such agencies for the Company until February 1986 when she discontinued such affiliation. Management believes the terms and rates of such insurance policies were reasonable and competitive with those offered by other insurance agencies. In December 1985, the Board of Directors passed a resolution to reimburse Mrs. Kingsborough for the cost of her reasonable travel expenses when accompanying Mr. Kingsborough on Company business trips. The amounts reimbursed to Mrs. Kingsborough during the fiscal year ended March 31, 1986 aggregated $18,300. In April 1986, the Board determined to discontinue the reimbursement of such expenses.

In August 1986, the Board of Directors partially accelerated the vesting of options held by Robert Goldberg, an Executive Vice President of the Company, to allow him to purchase the shares underlying the options prior to December 1986, when they would otherwise have vested.

In September 1986, the Company entered into an exclusive option and license agreement with a partnership composed of Paul Rago (a non-executive officer of the Company) and a major vendor of the Company. Under the agreement, the Company has the exclusive rights to develop and market certain school accessories previously developed by the partnership in exchange for 5.5% of net sales of such products. Should the Company not market any such products within 12 months after delivery of prototypes by the partnership, rights to such products will revert to the partnership. The agreement is for an initial term ending August 31, 1991 and grants the Company a five-year renewal option if the Company meets certain royalty levels. The terms of the agreement were not less favorable to the Company than could have been realized by an arm's-length transaction with unaffiliated parties.

No loans will be granted to any officers, affiliates or shareholders of the Company unless approved by a majority of the independent and disinterested Directors. All future transactions with affiliates of the Company will be on terms no less favorable to the Company than could have been realized by an arm's-length transaction with unaffiliated parties.

Reincorporation in Delaware and Limitation of Liability and Indemnification Matters

The Company intends to seek shareholder approval at the next annual meeting of shareholders to reincorporate in Delaware. The Company anticipates that its officers and directors and their affiliates, who collectively

own approximately 52% of the outstanding Common Stock, will vote to approve the reincorporation. This proposal will require the approval of a majority of the outstanding shares of Common Stock. Set forth below is a discussion of the proposed reincorporation.

In July 1986, Delaware enacted legislation that authorizes corporations to eliminate the personal liability of directors to corporations and their stockholders for monetary damages for breach or alleged breach of directors' fiduciary "duty of care." Under prior Delaware law, directors were accountable to corporations and their stockholders for monetary damages for conduct constituting gross negligence in the exercise of their duty of care. Although the new statute does not change a director's duty of care, it enables corporations to limit available relief to equitable remedies such as injunction or rescission. Numerous complaints alleging breach of directors' duty of care have been filed in connection with corporate mergers and acquisitions. The new statute permits corporations to limit available remedies of stockholders in connection with these transactions, as well as in other circumstances. The legislation has no effect on a director's liability for breach of the director's duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or knowing violations of law, a corporation's illegal payment of dividends and approval of any transaction from which the director derives an improper personal benefit. The validity and scope of the new statute has not been interpreted by the Delaware courts. The staff of the Securities and Exchange Commission has taken the position that the statute will have no effect on claims arising under the federal securities laws.

In connection with its proposed reincorporation in Delaware after this offering, the Company intends to include in its Certificate of Incorporation a provision limiting directors' liability to the fullest extent permitted by Delaware corporate law. Under the proposed Certificate of Incorporation, a director of the Company will not be personally liable to the Company or its stockholders for breach of fiduciary duties as a director, other than liability for breach of the director's duty of loyalty to the Company, liability for acts or omissions not in good faith or involving intentional misconduct or knowing violations of law, liability for transactions in which the director derived an improper personal benefit and liability for certain other specified acts. In addition, the proposed Certificate of Incorporation and the Company's proposed By-laws will provide that the Company will indemnify its directors and officers to the fullest extent permitted under Delaware law, including circumstances in which indemnification is otherwise discretionary. The Company plans to submit these charter and By-law provisions for approval by its shareholders shortly after the effective date of this offering. In addition, the Company intends to enter into separate indemnification agreements with its directors and officers that will require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers (provided the director or officer acted in good faith and in a manner he or she believed to be in or not opposed to the best interests of the Company and, with respect to a criminal proceeding, provided he or she had no reasonable cause to believe that the conduct was unlawful), to advance their

expenses incurred as a result of any proceeding against them as to which they could be indemnified and to obtain directors' and officers' insurance, if available on reasonable terms. The Company believes that the reincorporation in Delaware and its charter and By-law provisions and the proposed separate indemnification agreements are necessary to attract and retain qualified persons as directors and officers.

At present, there is no pending litigation or proceeding involving a director or officer of the Company where indemnification would be required or permitted. The Company is not aware of any threatened litigation or proceeding which may result in a claim for indemnification by any director or officer.

PRINCIPAL SHAREHOLDERS

The following table sets forth certain information regarding ownership of the Company's Common Stock as of March 31, 1987 (i) by each person who is known by the Company to own beneficially more than 5% of the Company's Common Stock, (ii) by each of the Company's directors, and (iii) by all executive officers and directors as a group.

Name (1)	Number	Percent
Donald D. Kingsborough (2)..... 4209 Technology Drive Fremont, CA 94538	4,375,699	19.7%
Josephine E. Abercrombie (3)..... 5005 Riverway, Suite 500 Houston, TX 77056	3,120,924	14.0

Robinson Interests, Inc. (3) ..... 5005 Riverway, Suite 200 Houston, TX 77056	1,814,568	8.2
John B. Howenstine (3)(4) ..... 5005 Riverway, Suite 500 Houston, TX 77056	970,503	4.4
W.O.W. Shares Partnership ..... 3731 Briar Park, Suite 200 Houston, TX 77042	724,063	3.3
Angelo M. Pezzani (5)	462,891	2.1
Barry H. Margolis (6)	152,732	.7
All directors and executive officers as a group (10 persons)	6,860,465	30.7%

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(1) The persons named in the table have sole voting and investment power with respect to all Common Stock beneficially owned by them, including shares which may be acquired within 60 days after March 31, 1987 through the exercise of stock options, subject to community property laws where applicable and the information contained in the footnotes to the table.

(2) Mr. Kingsborough is Chairman of the Board and Chief Executive Officer of the Company. Does not include 2,160 shares held in trust for the benefit of Mr. Kingsborough's children.

(3) Includes certain shares held of record as of March 31, 1987 by JSA Ventures, Ltd. which were subsequently distributed to each constituent partner other than Josephine E. Abercrombie.

(4) Mr. Howenstine is a Director of the Company.

(5) Mr. Pezzani is President, Chief Operating Officer, Secretary and a Director of the Company.

(6) Mr. Margolis is a Director of the Company. Represents shares held of record by W.O.W. Shares Partnership in which Mr. Margolis has a beneficial and financial interest. Does not include the remaining shares held of record by W.O.W. Shares Partnership, in which shares Mr. Margolis may be deemed to have a beneficial interest by virtue of his position as Managing Partner thereof, although such characterization should not be construed as an admission by Mr. Margolis that he is the beneficial owner thereof.

DESCRIPTION OF DEBENTURES

The Debentures will be issued under an Indenture (the "Indenture"), to be dated as of June 1, 1987, between the Company and Bankers Trust Company, as Trustee (the "Trustee"). A copy of the Indenture in the form in which it is to be executed is filed as an exhibit to the Registration Statement of which this Prospectus forms a part.

The following summaries of certain provisions of the Indenture (including the form of Debenture attached thereto) do not purport to be complete and are subject to, and qualified in their entirety by reference to, all the provisions of the Indenture, including the definitions therein of certain terms. The section and paragraph numbers appearing parenthetically below refer to sections and paragraphs of the Indenture and the form of Debenture, respectively, and wherever particular sections, paragraphs or defined terms of the Indenture or form of Debenture are referred to in this Prospectus, it is intended that such sections, paragraphs or defined terms be incorporated herein by reference.

General

The Debentures will be unsecured subordinated obligations of the Company in total principal amount of not more than $92,000,000 (including the Underwriter's over-allotment option) and will mature on June 1, 2012. The Debentures will bear interest from the date of issuance at the rate per annum shown on the cover page of this Prospectus, payable semiannually on June 1 and December 1 of each year ("Interest Payment Dates"), commencing December 1, 1987, to the registered holders on the preceding May 15 and November 15, respectively. (Paragraphs 1 and 2). Principal (and premium, if any) and interest on the Debentures will be payable, the Debentures will be convertible and exchangeable, and transfers thereof will be registrable at the corporate trust office of the Trustee at 4 Albany Street, New York, New York 10015. At the option of the Company, however, payment of principal and interest may be made by its check mailed to the Holder's registered address. (Paragraph 2).

The Debentures will be issued only in fully registered form in denominations of $1,000 or any integral multiple thereof. The Registrar need not transfer or exchange any Debenture selected for redemption, or transfer or exchange any Debenture for a period of 15 days before a selection of Debentures to be redeemed is to take place. (Paragraph 10). No service charge will be made for any registration of transfer or exchange of Debentures, but the Company may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith. (Section 2.06).

The Company does not intend to apply for listing of the Debentures on a national securities exchange but has

been advised by Smith Barney, Harris Upham & Co. Incorporated that it presently intends to make a market in the Debentures. No assurance can be given, however, as to the liquidity of, or trading markets for, the Debentures.

Conversion Rights

The Holder of any Debenture will have the right, at such Holder's option, to convert the principal amount thereof (in whole or in part that is an integral multiple of $1,000) into shares of Common Stock at any time prior to redemption and at any time prior to or on the day of maturity, initially at the conversion price stated on the cover page hereof. (Section 10.01). The right to convert Debentures called for redemption will terminate at the close of business on the redemption date, unless the Company defaults in making the payment due upon redemption. (Paragraph 8). For information as to notices of redemption, see "Redemption" below.

Debentures surrendered for conversion between a record date for payment of interest and the next Interest Payment Date (except Debentures called for redemption in whole or in part within such period) must be accompanied by payment of an amount equal to the interest payable on such Interest Payment Date on the Debentures surrendered for conversion. No other adjustment for interest or dividends is to be made upon conversion. (Paragraph 8). Fractional shares of Common Stock will not be issued upon conversion, but, in lieu thereof, the Company will deliver its check in the amount of the then current market value of the fractional share of Common Stock. (Section 10.03).

The conversion price will be subject to adjustment in certain events, including (a) the issuance of shares of Common Stock as a dividend or distribution on Common Stock, (b) the issuance to all holders of Common Stock of certain rights or warrants entitling them to purchase Common Stock at less than the current market price, (c) subdivisions, combinations and reclassifications of Common Stock, and (d) certain distributions to all holders of Common Stock or any of the Company's stock other than Common Stock, debt securities, assets (excluding certain cash dividends and distributions) or rights or warrants to purchase Common Stock (other than those mentioned above). (Sections 10.06, 10.07, 10.08). No adjustment in the conversion price will be required unless, among other things, cumulative adjustments amount to at least 1% of the conversion price then in effect. (Section 10.11). In addition, the Company may, at any time and upon 15 days' notice, make any voluntary reductions in the conversion price as it desires. (Section 10.09). In case of certain consolidations or mergers to which the Company is a party or the transfer of all or substantially all of the assets of the Company, each Debenture then outstanding will become convertible only into the kind and amount of securities and assets receivable upon the consolidation, merger or transfer by a holder of the number of shares of Common Stock into which such Debenture would have been converted immediately prior to such consolidation, merger or transfer. (Section 10.15).

Any adjustment to the conversion price shall be set forth in a notice mailed by the Company to all Holders of Debentures promptly after such adjustment. (Section 10.13).

Subordination of Debentures

The Debentures will be subordinated and subject, to the extent and in the manner set forth in the Indenture, to the prior payment in full of all Senior Indebtedness. (Section 11.01). Senior Indebtedness is defined as (a) any liability of the Company (other than the Debentures), whether now or hereafter outstanding for (i) borrowed money, (ii) purchase money obligations with an original maturity in excess of one year, or (iii) the leasing of any property with an original non-cancellable term in excess of one year, (b) without duplication, any liability of others described in the preceding clause (a) which the Company has guaranteed or for which it has assumed liability, and (c) any amendment, renewal, extension or refunding of any such liability described in (a) and (b) above, unless the terms of the instrument evidencing such debt provide that it is not superior in right of payment or performance to the Debentures. (Section 1.01). At June 3, 1987, the Company had Senior Indebtedness totalling approximately $90 million. In addition at June 3, 1987, the Company had approximately $32 million of standby letters of credit outstanding, which if drawn upon would result in additional Senior Indebtedness. The Indenture does not limit the amount of Senior Indebtedness that the Company may incur, and the Company expects from time to time to incur or assume additional Senior Indebtedness.

No payments of principal of premium, if any, sinking fund or interest on the Debentures may be made and no Debentures may be purchased by the Company if, at the time of such payment or purchase as a result thereof, a default in the payment of any Senior Indebtedness occurs

and is continuing that permits the holders of such Senior Indebtedness to accelerate its maturity and either the default is the subject of judicial proceedings or a default notice is received by the Company, except that Debentures acquired by the Company before the default and notice thereof or of the initiation of judicial proceedings may be credited towards a sinking fund payment. (Section 11.02). Upon any payment or distribution of assets of the company upon any dissolution, winding up, reorganization, liquidation of, or similar proceeding involving the Company, all holders of Senior Indebtedness shall be entitled to receive payment in full before the Holders of the Debentures will be entitled to receive or retain any payment on account thereof. (Section 11.03). Any payments or distributions made in violation of the subordination provisions of the Indenture shall be held in trust by the recipients for payment of all Senior Indebtedness remaining unpaid. (Sections 11.02, 11.03).

By reason of such subordination, in the event of insolvency, creditors of the Company who are holders of Senior Indebtedness may recover more, ratably, than Holders of Debentures, and creditors of the Company who are neither holders of Senior Indebtedness nor Holders of Debentures may recover less, ratably, than holders of Senior Indebtedness and more, ratably, than Holders of Debentures.

Optional Redemption

The Debentures will be redeemable upon not less than 30 nor more than 60 days' notice by mail, (a) on June 1 in each year commencing with the year 1997 through

the operation of the mandatory sinking fund described below, and (b) at any time on or after June 1, 1989, as a whole or in part, at the election of the Company, at the redemption prices set forth below, together in each case with accrued interest to the redemption date. (Paragraph 5). An installment of interest whose stated maturity is on the date fixed for redemption shall continue to be payable to the holders of record of such Debentures on the relevant record date. The redemption prices in the case of any redemption not made through operation of the sinking fund (expressed in percentages of the principal amount) are as follows for the 12-month period beginning June 1 of the years indicated.

Year	Redemption Price
1989	107.000%
1990	106.125%
1991	105.250%
1992	104.375%
1993	103.500%
1994	102.625%
1995	101.750%
1996	100.875%
1997 and thereafter	100.000%

Mandatory Redemption

Holders of Debentures will have the option for a specified period of 60 days, to require the Company to redeem the Debentures, in whole or in part, at 100% of the principal amount thereof, together with accrued interest to the date of redemption, upon the occurrence of either of the following events: (i) any person or group (an

"other entity"), within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934, attains beneficial ownership, within the meaning of Rule 13d-3 of the Securities Exchange Act of 1934, of at least 50% of the voting power for election of the Directors of the Company unless approved in advance or within 10 days thereafter by a majority of the Company's continuing Directors (as defined below), or (ii) the Company consolidates or merges with or sells or leases its properties and assets substantially as an entirety to any other entity, unless approved in advance by a majority of the Company's Continuing Directors. A "Continuing Director" is a member of the Board of Directors of the Company elected by the shareholders prior to the time the other entity acquired in excess of 10% of the voting power for the election of Directors of the Company or a person recommended to succeed a Continuing Director by a majority of the Continuing Directors.

The right of the Holders to require the redemption of the Debentures upon the occurrence of the above-described events may deter certain mergers, tender offers or other takeover attempts, thereby adversely affecting the market price of the Company's Common Stock. Because such an event is likely to occur upon the consummation of certain forms of takeovers, those forms of takeovers may be impeded if the person considering the takeover cannot finance the redemption of the Debentures upon the occurrence of such an event. Moreover, to the extent Debentures are redeemed, the Company will be deprived of the financing provided by the sale thereof.

In addition, the ability of the Company to obtain additional Senior Indebtedness based on the existence of the Debentures would be similarly adversely affected.

Sinking Fund

The Debentures require the Company to provide for the annual redemption of 5% of the original aggregate principal amount of the Debentures on June 1 of each of the years from 1997 to and including 2011 through the operation of a mandatory sinking fund. Upon at least 60 days' notice to the Trustee, the Company may, at its option, receive credit against sinking fund payments for the principal amount of (a) any Debentures redeemed or called for redemption (other than through the operation of the mandatory sinking fund), (b) any Debentures converted into Common Stock of the Company and not called for redemption through the operation of the mandatory sinking fund, and (c) any other Debentures delivered to the Trustee by the Company for cancellation. (Paragraph 6).

Modification of the Indenture and the Debentures

Amendments and supplements to the Indenture or the Debentures may be made by the Company and the Trustee with written consent of the Holders of a majority in principal amount of the outstanding Debentures; provided, that (a) no notice to or consent of any Holder is necessary for amendments or supplements that (i) cure any ambiguity, defect or inconsistency, (ii) comply with Sections 5.01 and 10.15 (governing the consolidation, merger or transfer of all or substantially all of the assets

of the Company) of the Indenture, (iii) provide for uncertificated Debentures in addition to or in place of certificated Debentures, or (iv) make any change that does not materially adversely affect the rights of any Holder (including but not limited to a supplement to the Indenture under Section 5.01); and (b) no such amendment, supplement or waiver, including a waiver pursuant to Section 6.04 of the Indenture, may, without the consent of each Holder affected, (i) reduce the amount of Debentures whose Holders must consent to an amendment, supplement or waiver, (ii) reduce the rate of or extend the time for payment of interest on any Debenture, (iii) reduce the principal of or premium on or extend the fixed maturity of any Debenture, (iv) make any change in Sections 6.04 or 6.07 or Article 11 that adversely affects the rights of any Holder, (v) waive a default in the payment of the principal of, or interest on, any Debenture, (vi) make any Debenture payable in money other than that stated in the Debenture, or (vii) make any change that materially adversely affects the right to convert any Debenture or that increases the conversion price of any Debenture. (Sections 9.01, 9.02).

Events of Default, Notice and Waiver

The following are to be events of default under the Indenture: (a) default for 30 days in the payment of any interest; (b) default in the payment of principal (upon maturity, redemption or otherwise) or premium, if any, when due; (c) default in the performance of any other covenant in the Indenture for 60 days after receipt of written notice from either the Trustee or the Holders of not less than 25% in principal amount of the outstanding

Debentures; (d) default under any indebtedness in excess of $10 million for borrowed money or any instrument evidencing or securing the same which results in a failure to pay, or an acceleration of, such debt; and (e) certain events in bankruptcy. (Section 6.01). The Company will be required to notify the Trustee within 30 days of any event of default under the Indenture. (Section 4.07). If any event of default shall happen and be continuing, the Trustee or the Holders of not less than 25% in principal amount of the outstanding Debentures may declare the Debentures immediately due and payable. The Holders of a majority in principal amount of the outstanding Debentures may rescind and annul a declaration of acceleration if all existing events of default have been cured or waived and if the rescission would not conflict with any judgment or decree obtained. (Section 6.02).

The Indenture will provide that the Trustee will be under no obligation, subject to its duty during default to act with the required standard of care, to exercise any of its rights or powers under the Indenture at the request or direction of the Holders of a majority in principal amount of outstanding Debentures, if, among other things, the Trustee does not have reasonable indemnification against the losses and expenses which it might incur in complying with such request or direction. Subject to such indemnification and certain other provisions, such Holders will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee, or exercising any trust or power conferred on the Trustee. (Sections 6.05, 7.01). Holders of the Debentures may not pursue any remedy with respect thereto or

to the Indenture unless the Trustee is notified of a continuing event of default, an adequate request is made upon it to institute a proceeding or action in connection with such remedy, it is offered satisfactory indemnification therefor, it does not comply with such request within 60 days thereafter and during such 60 day period the Holders of a majority in principal amount of the outstanding Debentures do not give the Trustee a direction inconsistent with the request. (Section 6.06).

The Holders of a majority in principal amount of the outstanding Debentures may on behalf of the Holders of all Debentures waive (a) compliance by the Company with any provision of the Indenture or the Debentures and (b) past defaults, except that neither defaults in payment of the principal of (or premium, if any) or interest on any Debenture can be waived, nor can a Holder's right to receive principal and interest payments and to bring suit to enforce such payments or the conversion right be affected, without the consent of each Holder affected thereby. (Sections 6.04, 6.07, 9.02). The Trustee may also waive compliance by the Company with any provision of the Indenture without notice to or consent of any Holder, provided that such waiver does not adversely affect the rights of any Holder. (Section 9.01).

The Company will be required to furnish to the Trustee annually a statement as to the performance by the Company of its obligations under the Indenture and as to any default in such performance. (Section 4.03).

Concerning the Trustee

Bankers Trust Company will serve as the Trustee under the Indenture and as the transfer agent and registrar for the Debentures. The Trustee is permitted to be a depository for funds of, make loans to, or perform services for the Company or its subsidiaries in the normal course of its business. However, the Indenture contains certain limitations on the right of the Trustee, should it become a creditor of the Company, to obtain payment of certain claims against the Company or to realize on certain property received in respect of any such claim, and requires the Trustee, if it acquires any conflicting interest (as defined in the Indenture), to eliminate such conflict or resign.

Governing Law

The Indenture and each Debenture shall be deemed to be a contract made under the laws of the State of New York, and for all purposes shall be construed in accordance with the laws of the State of New York.

CERTAIN FEDERAL INCOME TAX CONSIDERATIONS

Set forth below is a discussion of certain federal income tax consequences to initial holders of the Debentures under the Internal Revenue Code of 1986, as amended (the "Code"). The discussion is based on current law and does not purport to deal with all aspects of federal income taxation that may be relevant to investors in light of their personal circumstances, nor to investors subject to special treatment under the federal income tax

laws, such as dealers in securities, foreign persons or persons who acquire the Debentures at a price other than their initial offering price to the public. In addition, the discussion does not address foreign, state or local tax considerations. Investors should also be aware that the tax consequences to subsequent holders may differ. Prospective investors should consult their own tax advisors regarding the federal, state, local, foreign and other tax consequences of holding and disposing of the Debentures and the Common Stock.

Conversion of Debentures

No gain or loss should be recognized upon the conversion of a Debenture into Common Stock (except to the extent of cash received in lieu of a fractional share). The holder of a Debenture converted into Common Stock should generally have a carryover basis in such shares. Provided the Debenture is held as a capital asset, the holding period for the Common Stock should generally include the holding period of the Debenture. However, holders should be aware that the Internal Revenue Service is currently studying the federal income tax treatment of convertible debt generally and may eventually promulgate regulations which could, under certain circumstances, adversely affect a holder of a Debenture.

The conversion price of the Debentures may be adjusted if, among other things, the Company makes certain distributions to its shareholders and may be reduced at any time at the option of the Company. See "Description of Debentures." Under Section 305 of the Code, if the Company adjusts the conversion price or

otherwise reduces the conversion price of the Debentures, holders of the Debentures may, in certain circumstances, be viewed as receiving a "deemed distribution." In certain other instances, the absence of such an adjustment or reduction may result in a deemed distribution to the holders of the Common Stock. All or a portion of any such deemed distribution may be taxable as ordinary dividend income.

Sale or Redemption of Debentures or Sale of Common Stock

On a sale or redemption of the Debentures or a sale of the Common Stock, a holder will generally recognize gain or loss measured by the difference between the amount of cash and the fair market value of property received (except to the extent attributable to accrued interest) and the holder's tax basis in the Debentures or the Common Stock sold or redeemed, as the case may be. Such gain or loss should be capital gain or loss, provided the securities were held as capital assets, and will be long-term gain or loss if the securities were held more than six months (one year for securities considered acquired after 1987). However, holders should be aware that contrary to well-established law, one possible interpretation of recent proposed regulations would treat the excess of the redemption price of a Debenture over its face amount as contingent interest taxable as ordinary income.

Backup Withholding and Information Reporting

A holder may be subject to backup withholding at the rate of 20% with respect to dividends or interest paid on, or the proceeds of a disposition of, a Debenture or the Common Stock, unless such holder (a) is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules.

The Company will report to the holders of the Debentures or the Common Stock and the Internal Revenue Service the amount of any "reportable payments" for each calendar year, the amount of tax withheld, if any, with respect to payments on the Debentures or the Common Stock and the holder's name, address and taxpayer identification number.

Tax Reform

In October 1986, Congress enacted the Tax Reform Act of 1986 (the "1986 Act"). Although the 1986 Act provides for the elimination of the preferential treatment for capital gain income by lowering the rates on ordinary income and raising the rates on capital gain income, the 1986 Act continues the limitations on deductibility of capital losses. In addition, the rates introduced by the 1986 Act are not scheduled to become fully effective until 1988; for 1987, the capital gain tax rate differential, while diminished, continues. The 1986 Act also, among other things, modifies the alternative minimum tax, reduces the

dividends received deduction for corporate shareholders and eliminates the dividends received exclusion for individual shareholders.

DESCRIPTION OF CAPITAL STOCK

The Company's authorized capital stock consists of 50,000,000 shares of Common Stock and 1,000,000 shares of Preferred Stock.

Common Stock

As of March 31, 1987, 22,224,071 shares of Common Stock were outstanding and were held of record by approximately 3,500 shareholders. The holders of Common Stock are entitled to one vote for each share held of record on all matters submitted to a vote of shareholders and, upon giving notice required by law, may cumulate their votes in the election of directors. Subject to the dividend preferences applicable to any outstanding shares of Preferred Stock, holders of Common Stock are entitled to receive ratably such dividends as may be declared by the Board of Directors out of funds legally available therefor. In the event of liquidation, dissolution or winding up, holders of the Company's Common Stock are entitled to share ratably among themselves in all assets of the Company legally available for distribution and remaining after payment of liabilities and any preferential amounts payable in respect of the Preferred Stock. See "Preferred Stock." The outstanding shares of Common Stock are fully paid and non-assessable.

Preferred Stock

The Board of Directors has the authority to issue Preferred Stock on one or more series and to fix the rights, preferences, privileges and restrictions, including the liquidation preferences and the dividend, conversion, voting, redemption (including sinking fund provisions) and other rights, and the number of shares constituting any series and the designations of such series, without any further vote or action by the shareholders. Because the terms of the Preferred Stock may be fixed by the Board of Directors without shareholder action, the Preferred Stock could be issued quickly with terms calculated to defeat a proposed take-over of the Company, or to make the removal of management more difficult. Under certain circumstances this could have the effect of decreasing the market price of the Common Stock.

The Board of Directors without shareholder approval can issue Preferred Stock with voting and conversion rights which could adversely affect the voting power of the common shareholders. The Company has no outstanding Preferred Stock and does not presently contemplate the issuance of any Preferred Stock.

Shares Eligible for Future Sale

As of March 31, 1987, the Company had outstanding 22,224,071 shares of Common Stock. Of these shares, approximately 7,360,000 shares are eligible for sale in the open market without restriction. The remaining outstanding shares of Common Stock (the "Restricted Shares") were issued by the Company in private transactions between March 1985 and January 1986. The Restricted

Shares are eligible for public sale if registered under the 1933 Act or if sold in accordance with Rule 144 thereunder. The Restricted Shares are first eligible for sale in the public market under Rule 144 beginning upon expiration of a two year holding period commencing with their date of purchase. Approximately 10,910,000 Restricted Shares have been held for such two year period and are currently eligible for sale under Rule 144. Approximately 1,440,000 additional Restricted Shares become eligible for resale under the restrictions of Rule 144 at various times in August 1987. For a description of the Company's agreements with various shareholders to register their Common Stock under the 1933 Act, see "Outstanding Registration Rights" below.

Outstanding Registration Rights

The holders, or their transferees, of an aggregate of 13,062,435 shares of Common Stock (the "Holders") are entitled to certain registration rights with respect to such shares under the 1933 Act. Such Holders consist of Donald Kingsborough, John B. Howenstine, the 15 private investors in the state of Texas who purchased stock in the Company's private placement in August 1985, and their transferees. The Holders may request that the Company file a registration statement under the 1933 Act with respect to such shares, and the Company shall use its best efforts to effect such registration, subject to certain conditions including a requirement that the aggregate proposed public offering price of the securities to be sold is at least $4.0 million with respect to a registration on Form S-1 or S-2, and $2.0 million with respect to a registration

on Form S-3. Furthermore, whenever the Company proposes to register any of its securities under the Act, either for its own account or on account of other security holders exercising registration rights, the Company is required in each such instance to notify each Holder and include all shares of Common Stock which such Holders may request to be included in such registration; provided, among other things, that an underwriter of the offering has the right to limit the number of such shares being registered.

Transfer Agent and Registrar

Bank of America NT & SA serves as transfer agent and registrar for the Company's Common Stock.

UNDERWRITING

Upon the terms and subject to the conditions contained in the Underwriting Agreement, the Underwriter has agreed to purchase from the Company the principal amount of Debentures offered hereby.

The Company has been advised by the Underwriter that it proposes to offer the Debentures to the public at the offering price set forth on the cover page of this Prospectus and to certain dealers at such price less a concession of not in excess of 1.5% of the principal amount of the Debentures. The Underwriter may allow, and such dealers may reallow, a concession of not in excess of .5% of the principal amount of the Debentures

to other dealers. The Underwriter is committed to purchase and pay for all of the Debentures offered hereby if any Debentures are purchased.

The Company has granted an option to the Underwriter, exercisable by the Underwriter within 30 days after the date of this Prospectus, to purchase up to $12,000,000 principal amount of additional Debentures at the initial offering price less underwriting discounts and commissions, for the sole purpose of covering over-allotments.

Under the terms of the Underwriting Agreement, the Company has agreed not to sell, contract to sell or otherwise dispose of any shares of Common Stock for a period of 90 days after commencement of the public offering of the Debentures without the prior written consent of the Underwriter.

The Company has agreed to indemnify the Underwriter against certain liabilities, including liabilities under the 1933 Act.

LEGAL MATTERS

The legality of the sale of the Debentures offered hereby will be passed upon for the Company by Wilson, Sonsini, Goodrich & Rosati, a Professional Corporation, Palo Alto, California. Orrick, Herrington & Sutcliffe, New York, New York, is acting as legal counsel for the Underwriter in connection with certain legal matters relating to the sale of the Debentures offered hereby.

EXPERTS

The consolidated financial statements of the Company as of March 31, 1986 and 1987 and for the years then ended included in this Prospectus and the related supplemental schedules included elsewhere in the Registration Statement have been examined by Deloitte Haskins & Sells, independent certified public accountants, as set forth in their opinions appearing elsewhere in this Prospectus and Registration Statement, and have been so included in reliance upon such opinions given upon the authority of such firm as experts in auditing and accounting.

WORLDS OF WONDER, INC.

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OPINION OF INDEPENDENT PUBLIC ACCOUNTANTS

Worlds of Wonder, Inc.:

We have examined the consolidated balance sheets of Worlds of Wonder, Inc. as of March 31, 1986 and 1987 and the related consolidated statements of income, shareholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of the Company and its subsidiaries at March 31, 1986 and 1987 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

DELOITTE HASKINS & SELLS
Oakland, California
May 14, 1987

WORLDS OF WONDER, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended March 31, 1986 and 1987

	1986	1987
	(In thousands, except per share amounts)	
Net sales	$93,087	$327,422
Operating costs and expenses:		
Cost of sales	52,701	207,732
Advertising and promotion	11,802	50,669
Selling and distribution	6,044	20,732
General and administrative	5,344	18,736
Total operating costs and expenses	75,891	297,869
Income from operations	17,196	29,553
Interest expense, net	(1,302)	(3,439)
Other income (expense), net	(620)	2,779
Income before taxes on income	15,274	28,893
Taxes on income	7,172	10,253
Net income	$ 8,102	$ 18,640
Net income per share	$.43	$.85
Shares used in computing net income per share	18,876	21,923

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

CONSOLIDATED BALANCE SHEETS

March 31, 1986 and 1987

ASSETS

	1986	1987
	(In thousands, except share data)	
Current assets:		
Cash	$ 1,361	$ 1,816
Accounts receivable – net	45,925	162,538
Inventories	12,259	56,347
Prepaid expenses	3,938	22,732
Total current assets	63,483	243,433
Property – net	4,505	15,215
Other assets	2,273	14,339
	$70,261	$272,987

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Bank lines of credit	$20,088	$ 71,989
Accounts payable	18,299	56,733
Income taxes payable	8,419	6,666
Accured liabilities	8,055	38,395
Subordinated notes payable to shareholders	3,651	–
Total current liabilities	58,512	173,783
Deferred income taxes	125	345

Commitments and Contingencies (Notes 2 and 8)

Shareholders' equity:		
Preferred stock – no par value, 1,000,000 shares authorized; no shares outstanding	–	–
Commonstock – no par value, 50,000,000 shares authorized; shares outstanding: 18,017,435 in 1986 and 22,224,071 in 1987.....	3,547	72,117
Less shareholder note receivable	(25)	–
	3,522	72,117
Retained earnings	8,102	26,742
Shareholders' equity	11,624	98,859
	$70,261	$272,987

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the Years Ended March 31, 1986 and 1987

	Common Stock		Shareholder Note Receivable	Retained Earnings
	Shares	Amount		
	(In thousands except share data)			
Common shares issued for:				
Cash	11,877,935	$ 3,431		
Development and marketing rights	4,488,000	10		
Standby letter of credit	1,620,000	53		
Compensation	16,500	28		
Exercise of stock options	15,000	25	$(25)	
Net income				$ 8,102
Balances, March 31, 1986	18,017,435	3,547	(25)	8,102
Common shares issued for:				
Cash:				
Public offering of stock, net	4,000,000	66,570		
Exercise of stock options	133,558	328	25	
Acquisition of subsidiary	73,078	1,672		

Net income				$18,640
Balances, March 31, 1987	22,224,071	$72,117	$ –	$26,742

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

For the Years Ended March 31, 1986 and 1987

	1986	1987
	(In thousands)	
Operations:		
Net income	$ 8,102	$ 18,640
Items not requiring working capital:		
Depreciation and amortization	533	3,204
Deferred income taxes	125	220
Other	114	142
Working capital provided by operations	8,874	22,206
Effect of changes in:		
Receivables	(45,925)	(116,613)
Inventories	(12,259)	(44,088)
Prepaid expenses	(3,938)	(18,794)
Accounts payable	18,299	38,434
Income taxes payable	8,419	(1,753)
Accrued liabilities	8,055	30,340
Cash used by operations	(18,475)	(90,268)
Financing activities:		
Common stock issued	3,522	68,595
Borrowings on bank lines of credit, net	20,088	51,901
Subordinated borrowings (repayments)	3,651	(3,651)
Cash provided by financing activities	27,261	116,845

Investment activities:		
Purchases of property, net.....	(4,929)	(13,608)
Acquisition of subsidiaries and affiliates	–	(1,936)
Investment in other assets.....	(2,496)	(10,578)
Cash used for investment activities.....	(7,425)	(26,122)
Net increase in cash.....	1,361	455
Cash at beginning of year.....	–	1,361
Cash at end of year	$ 1,361	$ 1,816

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. *Operations and Significant Accounting Policies*

Operations

Worlds of Wonder, Inc. (the "Company"), a California corporation, is engaged in the design, development, marketing and distribution of children's products. Operations commenced in April 1985, and product shipments began in August 1985.

Principles of consolidation

The consolidated financial statements include the Company and its wholly-owned subsidiaries. Investments in unconsolidated subsidiaries in which the Company has a 20% to 50% interest are recorded on the equity method.

Inventories

Inventories consist primarily of finished goods and are stated at the lower of cost (on the first-in, first-out basis) or market.

Prepaid expenses

Prepaid expenses includes the cost of certain point of purchase displays held by retailers; these displays are generally amortized over 12 months. Prepaid expenses also includes prepaid advertising, representing media

time received in exchange for certain of the Company's products. Such transactions are recorded based upon the fair market value of the media time received or the value of the Company's products, whichever is more clearly determinable; these costs are expensed as the related media time is used.

Property

Property is stated at cost and depreciated using the straight-line method over estimated useful lives of three to five years for machinery and equipment and five years for furniture and fixtures. Product graphics and tape production costs are amortized on a straight-line basis over the anticipated market lives of the related product lines.

Other assets

Other assets include goodwill resulting from acquisition of certain of the Company's subsidiaries, purchased product rights, advance royalties and television production costs. Goodwill is amortized over the periods estimated to be benefited; purchased product rights are amortized over the estimated market lives of the products; and television production costs are amortized on a pro-rata basis over the estimated related revenues.

Sales

Sales are recognized upon shipment, net of estimated returns and allowances.

Product warranties

Provision is made at the time of sale for the estimated costs to repair or replace products covered by the Company's warranties.

Product development

Product development costs are expensed as incurred and totaled $1,420,000 in 1986 and $6,227,000 in 1987. Such costs are included in general and administrative expenses.

Income taxes

Deferred income taxes are provided for income and expense items which are recognized in different years for tax purposes than for financial reporting purposes.

Net income per share

Net income per share is computed using the weighted average number of outstanding common shares and common share equivalents. The computation assumes that common shares issued and stock options granted prior to the Company's initial public offering in June 1986 were outstanding from the Company's inception.

Reclassifications

Certain fiscal 1986 amounts have been reclassified to conform to fiscal 1987 classifications.

2. *Transactions with Independent Designers and Licensees*

In February 1985, Donald D. Kingsborough, the Company's Chief Executive Officer, negotiated a Development and Marketing Agreement ("Agreement") with Alchemy II, Inc. ("Alchemy"); the Agreement was subsequently assigned to the Company. This Agreement, as amended, granted the Company exclusive worldwide manufacturing and distribution rights to present and future retail products incorporating Alchemy's electromechanical animation technology and to products incorporating certain characters developed by Alchemy. In exchange, the Company granted Alchemy separate royalties on sales of articles using the technology and products using the characters.

The Company's relationship with Alchemy previously involved a number of disputes. In December 1986, the Company and Alchemy amended the Agreement to resolve all outstanding disputes. In conjunction with the settlement, the Company loaned Alchemy $2,000,000 in connection with Alchemy's repurchase of a minority stockholder's interest in Alchemy. As a condition of the repurchase, the minority stockholder agreed to withdraw two actions filed against Alchemy, the Company and Mr. Kingsborough. The loan to Alchemy is repayable over seven years, is interest-free for the first two years and bears interest thereafter at a rate equal to the Company's average borrowing rate, subject to quarterly adjustments as this rate changes.

Cost of sales includes royalty expense to Alchemy of $5,755,000 in 1986 and $13,323,000 in 1987. The Company

also paid Alchemy $862,000 in 1986 and $721,000 in 1987 for the production of story cassette tapes and the development of specified products.

Substantially all of Alchemy's assets, including royalties due Alchemy by the Company, are pledged to the Company as collateral for certain of the loans and advances made to Alchemy.

The Company has also acquired certain products rights and technologies from other independent designers. These agreements generally provide for an initial payment and subsequent royalty or royalty-type payments based on net sales of the new products or products utilizing the technology. Royalty expenses under these agreements were not significant in fiscal 1986 or fiscal 1987.

The Company has also acquired under various license agreements the rights to certain well-known children's characters. These exclusive rights allow the Company to manufacture and sell animated talking plush and other toys incorporating the characters in exchange for royalties based on net sales of the products. Renewal of certain of these agreements is subject to specified conditions being met. Royalty expense under these agreements totaled $1,736,000 in 1987 (none in 1986). Future minimum royalty commitments under these agreements were $4,800,000 at March 31, 1987.

3. ***Bank Lines of Credit***

At March 31, 1987, the Company had borrowings of $71,989,000 under a bank operating line which allows

maximum borrowings of the lesser of $110 million or 75% of eligible accounts receivable. At March 31, 1987, $18,676,000 was available under this line. The line, which expires September 30, 1987, bears interest at prime plus 1¼% and is secured by the Company's assets. Under the terms of the bank credit agreement, the Company may not declare any dividends on its outstanding stock.

At March 31, 1987, the Company also had outstanding standby letters of credit totaling $16,980,000 under a $35 million import financing line. The Company pays a fee of 1½% per annum on the outstanding amount. The line, which expires on June 30, 1987, is secured by inventories and receivables.

In April 1987 the Company obtained a $35 million unsecured import financing line. The Company will pay a fee of 1⅜% per annum on any outstanding amounts. The line expires on December 31, 1987.

4. ***Capital Financing***

During fiscal 1986, the Company issued a total of 13,770,000 common shares to its founders in exchange for $253,000 in cash, for the assignment of the Agreement with Alchemy, and for assistance in obtaining bank financing; such assistance was in the form of a $9 million standby letter of credit made available in August 1985 by a shareholder for the Company's use. The shares issued to the founders for such agreement and financing were recorded at the founders' approximate cost.

Subordinated notes payable to shareholders, bearing interest at 10%, were issued in conjunction with the above issuance of stock. These notes were repaid in June 1986.

During fiscal 1986, the Company also sold 1,783,500 common shares for $178,000 to officers pursuant to employment agreements and 2,432,435 common shares for $3,000,000 to unrelated parties.

In June 1986, the Company sold 4,000,000 common shares in a public offering. Net proceeds, after underwriting discounts and commissions and expenses of $5,430,000, were $66,570,000.

5. *Taxes on Income*

The provisions for taxes on income are as follows:

	1986	1987
	(In thousands)	
Currently payable:		
Federal	$ 6,651	$ 5,130
State	1,521	2,473
Foreign	232	3,858
	8,404	11,461
Deferred:		
Federal	(1,114)	(278)
State	(118)	(110)
Foreign	–	(820)
	(1,232)	1,208)
Total	$ 7,172	$10,253

The components of the deferred tax provision are as follows:

	1986	1987
	(In thousands)	
Warranty and returns reserves ..	$ (839)	$(1,614)
Prepaid advertising and promotion	533	1,090
State taxes.....	(700)	(499)
Cooperative advertising allowances.....	(525)	–
Prepaid taxes related to foreign subsidiaries.....	–	(244)
Other.....	299	59
Total.....	$(1,232)	$(1,208)

WORLDS OF WONDER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The provisions for income taxes differ from the amount computed at the U.S. Federal statutory income tax rate (46%) as follows:

	1986	1987
	(In thousands)	
Federal income tax at statutory rate.....	$ 7,026	$13,291
State taxes, net of Federal income tax benefit.....	758	1,276
Effect of foreign tax rates.....	(341)	(4,604)
Investment and research and development tax credits	(308)	(304)
Other	37	594
Provisions for taxes on income....	$ 7,172	$10,253

No provision has been made for taxes payable upon distribution of certain unremitted earnings of the Company's foreign subsidiaries because such earnings have been or are expected to be reinvested in those operations. Cumulative unremitted earnings for which the Company has not provided such taxes were approximately $18,000,000 at March 31, 1987.

6. Stock Option Plan

Under the Company's stock option plan, options to buy 1,285,192 common shares at an average price of $6.66 per share were outstanding at March 31, 1987, of which 122,255 shares were exercisable. An additional 566,250 shares were available for future grants. The following stock options were exercised:

	1986	1987
Total shares.....	15,000	133,558
Average price per share...	$2.33	$2.37

7. Additional Financial Statement Information:

Accounts receivable consists of:

	1986	1987
	(In thousands)	
Trade accounts receivable	$48,880	$169,688
Other receivables	28	2,771
	48,908	172,459
Less allowances for doubtful accounts and estimated returns	(2,983)	(9,921)
Accounts receivable – net	$45,925	$162,438

Property consists of:

Produce graphics and tape production	$ 1,496	$ 5,613
Tools, dies and molds	1,155	4,854
Machinery and equipment	140	891
Furniture and fixtures	2,136	5,926
Leasehold improvements	2	1,253
	4,929	18,537
Less accumulated depreciation and amortization	(424)	(3,322)
Property – net	$ 4,505	$ 15,215

In July 1986 the Company purchased a 20% investment in Revell Engineering Inc. ("Revell"). During fiscal 1987, the Company paid Revell $2,100,000 for tooling.

During fiscal 1986 and fiscal 1987, one customer accounted for 16% and 19%, respectively, of the Company's net sales. A second customer accounted for 13% of the Company's net sales in fiscal 1987.

During fiscal 1987, the Company acquired Greybridge for $1,672,000 in Company stock, in a business combination accounted for as a purchase. Greybridge designs, manufactures and markets pre-school toys. Had the acquisition taken place at the beginning of fiscal 1987, the consolidated results of operations of the Company would not have been significantly different.

8. *Commitments and Contingencies*

The Company leases office and warehouse facilities and equipment under operating leases. Rental expense was $625,000 in 1986 and $3,495,000 in 1987. Future minimum rental commitments are as follows:

Year ending March 31:	
1988	$ 4,720,000
1989	2,401,000
1990	2,023,000
1991	1,243,000
1992	19,000
Total	$10,406,000

The Company has employment contracts with certain individuals with total minimum obligations of $2,000,000 per year in decreasing amounts through February 1991. Certain of the contracts provide for severance pay equal to amounts due under the remaining contract terms for termination without cause, severance pay of lesser amounts for terminations under certain other conditions, and/or payments through the remaining contract terms in the event of disability or death.

In addition to the commitments set forth above, the Company is also a party to various contracts and commitments, including those related to contract manufacturing and media advertising. These commitments, which may be substantial at various times during the fiscal year, amounted to approximately $57,000,000 at March 31, 1987. The Company is also subject to various claims and lawsuits in its normal course of operations. Management believes that the ultimate resolution of these matters will not have a material impact on the Company's financial statements.

9. *Subsequent Events*

In May 1987, the Company filed a registration statement with the Securities and Exchange Commission for a proposed offering of approximately $100,000,000 of convertible subordinated debentures.

95-154

No. (2)

Supreme Court, U.S.
FILED
JUL 25 1995
CLERK

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

APPENDIX TO PETITION FOR WRIT OF CERTIORARI VOLUME II – App. 196 through App. 356

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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

(Filed Oct. 27, 1992)

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Master File No. C-87-5491 SC *Class Action*
This Document Relates To: ALL ACTIONS.	THE DECLARATION OF ALBERT ROSSI, JR. Date: December 11, 1992 Time: 10:00 a.m. Place: Courtroom of the Honorable Samuel Conti

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I, ALBERT ROSSI, JR. C.P.A., DECLARE AND STATE:

1. I am a Certified Public Accountant, licensed to practice in the State of California. I make this declaration in opposition to Defendants' Motions for Summary Judgment or Summary Adjudication of Claims. I have been retained by plaintiffs' counsel in this matter as an expert witness and consultant regarding accounting, auditing, and financial statement disclosure issues. I have over sixteen years of experience as an accountant and auditor for both publicly held and privately held business organizations. I have served as an accounting and auditing expert, investigative accountant and/or litigation consultant in the area of accounting and auditing in over 60 lawsuits, including more than 50 securities fraud class actions. Additional qualifications are set forth on my resume, which is attached hereto as Exhibit A. My opinions expressed herein are based on my background and experience and on my personal review of the materials specified. If called upon as a witness, I could and would testify competently thereto.

2. I have reviewed the documents submitted by defendant Deloitte & Touche ("Deloitte") in support of its Motion for Summary Judgment. Additionally, I have reviewed the following documents in connection with this engagement:

a. Deloitte's work papers for the following:

(1) Deloitte's audits of the financial statements of Worlds of Wonder, Inc. ("WOW") for the fiscal years ended March 31, 1986 and 1987;

(2) Deloitte's audit of WOW's financial statements as of September 29, 1985;

(3) Deloitte's quarterly reviews for the quarters included in fiscal 1987 and 1988;

(4) Deloitte's engagements in connection with WOW's June 1986 initial public stock offering and June 1987 debenture offering;

b. Deloitte's correspondence files produced in this litigation;

c. the Prospectus for WOW's June, 1986 initial public offering of common stock;

d. the Prospectus for WOW's June 1987, public offering of convertible subordinated debentures;

e. The Third Consolidated Amended Complaint in this action (the "Complaint");

f. WOW's financial statements as filed on forms 10-K and 10-Q for fiscal 1986 and 1987, and for the quarters of fiscal 1988;

g. thousands of documents produced by WOW and third parties in this litigation;

h. the deposition transcripts and exhibits of witnesses Todd A. Wilson, James Tindal, Kerry MacVay, Warren Solt, and William McKee;

i. the transcripts and exhibits of the depositions of Eric Roberts and Ronald Barrington, which I also attended;

j. excerpts from the depositions of Mark Bradlee, Angelo Pezzani, Donald Kingsborough and James Lee Whims; and

k. the declarations of John G. Forsythe and Pat Landversicht.

My firm has spent in excess of 575 hours reviewing and analyzing the above documents, and of that, I have personally spent in excess of 350 hours.

I.

SUMMARY OF OPINIONS

A. False and Misleading Financial Statements

3. The following is an overview of my opinions contained in this declaration regarding WOW's financial statements:

a. WOW's March 31, 1987, financial statements were materially false and misleading and in violation of Generally Accepted Accounting Principles ("GAAP") in that:

(1) Approximately $32 million of revenue was improperly recognized under WOW's March, 1987 FOB Hong Kong and Transfer programs. This includes, without limitation, WOW's large transaction at or near fiscal year-end with K-Mart Corporation (the "K-Mart Transaction").

(2) Approximately $9 million of revenue was improperly recognized under barter transactions

with Admerex International and Deerfield Communications, under which WOW exchanged discontinued products for credits applicable to the future purchase of advertising media time.

(3) At a minimum, the financial statements failed to disclose a contingent liability for price protection on goods recorded as "sales" at March 31, 1987, and the Prospectus failed to disclose the practice of price protection under the business description and MD&A sections.

(4) The financial statements failed to include an adequate provision for sales returns and allowances.

(5) The financial statements failed to include adequate inventory reserves for obsolete, defective, and excess inventories, including inventory valuation reserves.

(6) The financial statements failed to include disclosure of significant fourth quarter adjustments, as required by APB Opinion No. 28.

(7) The financial statements failed to disclose the significant impact on subsequent quarters' revenue resulting from the March 1987 Dating Program.

b. WOW's December 31, 1986, financial statements were materially false and misleading and in violation of GAAP in that:

(1) Approximately $20 million of revenue was improperly recognized under WOW's December, 1986 FOB Hong Kong program.

(2) At least $2.0 million of revenue was improperly recognized on sales of products shipped subsequent to December 31, 1986.

(3) Approximately $2.5 million of revenue was improperly recognized on products consigned to BNS Trade S.A. and Wilson Printing & Premiums, Inc.

c. WOW's March 31, 1986, financial statements were materially false and misleading and in violation of GAAP in that the financial statements failed to include an adequate provision for sales returns and allowances.

B. Deloitte's Audit Failures

4. The following is an overwiew of my opinions contained in this declaration regarding Deloitte's conduct in this case:

a. Deloitte recklessly failed to comply with Generally Accepted Auditing Standards ("GAAS") (AU Section 150) in the conduct of its audit of the March 31, 1987 and 1986 financial statements, including its subsequent events procedures with respect to WOW's June, 1987 public offering of convertible debentures, as is set forth below, in that:

(1) Deloitte failed to maintain in all matters relating to the examination an independence in mental attitude (AU Section 220).

(2) Deloitte failed to exercise due professional care in the performance of its audits and the preparation of its reports (AU Section 230).

(3) Deloitte failed to obtain sufficient competent evidential matter to afford a reasonable basis for its opinions regarding the financial statements (AU Section 330).

(4) Deloitte failed to state in its report that the financial statements did not present fairly the financial position and results of operations of WOW in conformity with GAAP (AU Sections 410 and 411).

(5) Deloitte failed to require that the financial statements contain disclosure of material matters required by GAAP (AU Section 430).

(6) Deloitte failed to adequately plan and supervise the assistants performing the audit work (AU Section 310).

(7) Deloitte failed to qualify its report on WOW's March 31, 1987 financial statements as a result of the uncertainties regarding WOW's ability to continue as a going concern (SAS No. 34).

(8) Deloitte failed to comply with subsequent events procedures with respect to subsequent events from the date of its report up to the effective date of the offering (AU Section 711).

(9) Deloitte's conduct was an extreme departure from the standards of ordinary care for an accountant and auditor. The danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it.

C. Deloitte's Knowledge and Substantial Assistance in the Preparation and Dissemination of the False and Misleading Financial Statements

5. In my opinion, Deloitte knew of and substantially assisted in the preparation and dissemination of WOW's false and misleading financial statements, and was on notice of facts demonstrating their falsity.

D. Response To May Declaration

6. In a declaration filed with Deloitte's moving papers (the "May Declaration"), Alan May, Jr., C.P.A., has expressed the opinion that Deloitte's audits of financial statements for the fiscal years ended March 31, 1987 and 1986 were in accordance with GAAS, and that certain transactions were accounted for on WOW's financial statements in a manner consistent with GAAP. To the extent and for the reasons set forth more specifically hereinafter, I disagree categorically with those opinions.

II.

OPINIONS REGARDING WOW'S FISCAL YEAR 1987 FINANCIAL STATEMENTS

A. Introduction: Wow's December 10th Dating Program

7. In March, 1987, WOW offered certain of its customers a program under which the customers could purchase products from WOW and not be required to pay for the goods until December 10, 1987. The prospectus for WOW's 1987 debenture offering uses the word "dating" to describe these extended payment terms. WOW's sales

under the "dating" program comprised three types of transactions:

(a) "Transfer Sales". Sales were purportedly made to certain customers under terms which provided that the goods sold would be transfered [sic], not to the customer's premises, but within WOW's warehouses (including public warehouses), and segregated. For goods already in a public warehouse, ownership was purportedly "transferred" to the customer within the public warehouse.

(b) "FOB Sales". Sales were purportedly made to certain customers FOB Hong Kong (hereinafter, "FOB Sales"). Under the FOB program, the customer theoretically assumed ownership of the goods either upon their shipment from Hong Kong to the United States or while they were in transit from Hong Kong to the United States.

(c) "Dated Sales". Sales were made with extended payment terms, with customer payment not due until December 10, 1987. This category included FOB and Transfer Sales, which were made with extended payment terms, and sales where the product was shipped to customer locations from WOW's U.S. warehouses, allegedly as of March 31, 1987.

8. Under the December 10th dating program, WOW recorded sales of approximately $52 million at March 31, 1987 to the following customers:

CUSTOMER	AMOUNT
K mart Corporation	$16,363,686
Zayre Corporation	4,174,465
Toys R Us	2,766,172
Wal-Mart Stores	6,050,438
Gold Circle	190,247
Hills	765,808
Bradlee's	725,638
Child World	559,547
Lionel Leisure	271,946
Other	20,000,000
TOTAL	$51,868,000

9. WOW's sales under its FOB and Transfer Programs were highly material to the Company's fiscal year 1987 financial statements. The $32 million of revenue attributable to these sales represented approximately 10% of WOW's fiscal year 1987 revenues, and produced income before taxes of approximately $12 million , or approximately 42% of WOW's reported pre-tax income for the fiscal year as a whole. In other words, if revenue had not been recognized on these transactions, WOW's reported profit for the 1987 fiscal year would have been flat with the prior year, while revenues in the current year had more than tripled. The importance of these transactions to WOW's *quarterly* financial results was even more pronounced. The FOB and Transfer Sales represented *nearly one-third* of WOW's reported net revenues for the fourth quarter of fiscal 1987 – the quarter immediately prior to WOW's June, 1987 debenture offering. Had the revenue from these transactions not been recorded in the fourth quarter, in place of the fourth-quarter pre-tax profit of approximately $291,000 reported

in the 1987 Prospectus, WOW would have reported a quarterly pre-tax *loss* of *nearly $12 million*.

B. The K-Mart Transaction

10. Among the transactions subject to December 10 "dating" terms was the K-Mart Transaction, in which WOW purportedly "sold" to K-Mart $18.2 million of product pursuant to "Blanket Order No. 3" issued by K-Mart to WOW. Less discounts, allowances and other adjustments, this transaction produced reported net revenues in fiscal year 1987 and the fourth quarter thereof of $16,363,686. The K-Mart Transaction, in and of itself, was material to WOW's fiscal 1987 financial statements. The revenue recorded pursuant to that transaction was 5% of the Company's reported revenues for fiscal 1987 and produced approximately $6 million in pre-tax income. Had revenue not been recognized on the transaction, WOW's reported pre-tax income for fiscal 1987 would have been reduced by more than 20%, and the Company would have reported a fourth-quarter pre-tax loss of some $5.7 million.

11. In my opinion, it was improper under GAAP for WOW to recognize revenue and related earnings in connection with the K-Mart transaction in fiscal year 1987. Indeed, in my view, the question is not even a close one. Moreover, Deloitte's audit work on the K-Mart Transaction fell far short of the level necessary to satisfy GAAS. No reasonable auditor, knowing what Deloitte knew about the K-Mart transaction, would have rendered a "clean" audit opinion on WOW's fiscal 1987 financial

statements. In the sections that follow, I explain the reasons for my opinions.

(1) Terms of the K-Mart Transaction

12. The principal terms of the K-Mart Transaction were set forth in Blanket Order No. 3 and in a letter agreement between WOW and K-Mart bearing the date March 28, 1987 (the "Letter Agreement"). A copy of the K-Mart Letter Agreement and associated documents is attached to the declaration of Alan R. Plutzik, filed herewith, as Exhibit 50. Exhibits to the Plutzik Declaration are hereinafter referred to in the form, "Exhibit ___."

(a) Timing of Order

13. The Letter Agreement stated that Blanket Order No. 3 "will be issued to Worlds of Wonder only upon K-Mart's receipt of a signed copy of this letter and the attached Co-op Advertising Authorization and Specifications form." See Exh. 50 at page WOR0107030, first unnumbered paragraph.

(b) Product to be Purchased and Price

14. The Letter Agreement provided that upon the issuance of Blanket Order No. 3, K-Mart would purchase specified amounts of WOW products with an aggregate gross wholesale price of $18.2 million, less a 3% Co-op Advertising Allowance and a special "early buy and product promotion" deduction of $500,000. Exhibit 50 at ¶¶ 1, 4.

(c) "Shipment" to Public Warehouse

15. Under the Letter Agreement, the merchandise "purchased" by K-Mart pursuant to Blanket Order No. 3 would not be shipped immediately to K-Mart. Indeed, K-Mart had no obligation *ever* to take delivery of it. Rather, the merchandise was to be sent to a public warehouse and drawn down by K-Mart on an "as-needed basis". *Id.*, ¶ 1.

(d) Risk of loss

16. WOW was to bear the risk of loss, damage or physical destruction of the product while it was in the public warehouse or in transit to K-Mart.

(e) Distribution Orders and Right of Cancellation

17. To draw down the product, K-Mart could issue "distribution orders" to WOW at any time specifying the "ship to" point (presumably, one of K-Mart's stores or warehouses) to which the merchandise was to be sent and the date by which it must be delivered. WOW was then responsible for shipping the goods, at its own expense, from the public warehouse to the destination specified by K-Mart. If WOW failed to cause the merchandise to be delivered by the deadline date, K-Mart had the right to "cancel the merchandise" covered by that distribution order and need not pay for it. *Id.*

(f) Warehousing Costs

18. Under Paragraph 3 of the Letter Agreement, the costs of warehousing the merchandise were to be paid by K-Mart, up to a maximum of $15,000 per month or $250,000 per year, with any excess paid by *WOW*. *Id.*, ¶ 3. However, the very next paragraph of the Letter Agreement provided that K-Mart could take a corresponding $250,000 deduction against moneys due to WOW "to cover special handling and inventory charges". *Id.* ¶ 4. Therefore, the Letter Agreement provided, in effect, that WOW would pay all of the costs of storing the product until K-Mart wanted it. The Declaration of John G. Forsythe, WOW's former Manager of Credit and Collections, which I have reviewed, confirms that conclusion. According to Mr. Forsythe, the Credit and Collections Department was instructed that whatever amounts K-Mart paid the warehouse were to be immediately deducted from K-Mart's account payable to WOW. Forsythe Declaration at ¶ 42.

(g) "Stock Balancing"

19. The Letter Agreement gave K-Mart a right to "stock balance" – *i.e.*, to return any or all of the product which was in either the public warehouse or K-Mart's own warehouses as of December 31, 1987, in exchange for other WOW products of K-Mart's choosing. The new products were to be selected on or before January 31, 1988, and delivered on or before July 31, *1988 – sixteen months* after the ostensible date of the Letter Agreement. If K-Mart elected to avail itself of its right of "stock

balancing", WOW was required to pay K-Mart's costs of returning the goods K-Mart no longer wanted, *as well as* the costs of sending new goods to K-Mart in exchange for the old. Moreover, if WOW failed to deliver the new goods by the deadline date set by K-Mart, K-Mart could cancel the order to the extent of those goods and K-Mart would not need to pay for either the returned merchandise or the new merchandise for which K-Mart had attempted to exchange it. Letter Agreement, ¶¶ 5, 7.

(h) "Dating"

20. K-Mart was not required to pay for any of the goods until, at the earliest, December 10, 1987. *Id.*, ¶ 6.

(i) K-Mart Reservation of Rights

21. K-Mart reserved the right to change shipping schedules *or quantities* at its discretion. *Id.*, ¶ 10; form of Blanket Order No. 3, attached to Letter Agreement, at p. WOR0107033.

(2) Under GAAP, Revenue Should Not Have Been Recognized on the K-Mart Transaction

22. As noted above, WOW recorded revenue of over $16 million in its fiscal year ended March 31, 1987 from the K-Mart Transaction. In my opinion, the recognition of revenue on the K-Mart transaction in the 1987 fiscal year was forbidden by GAAP. No revenue should have been recognized on this transaction in fiscal 1987. The inclusion of revenue from the K-Mart Transaction in WOW's

fiscal 1987 financial statements rendered those financial statements materially false and misleading. In approving WOW's recognition of revenue in connection with the K-Mart transaction, Deloitte re lessly violated GAAS and substantially assisted WOW in promulgating false financial statements.

(a) Revenue Should Not Have Been Recognized on the K-Mart Transaction Because That Transaction Fails to Meet GAAP's Revenue Recognition Requirements for Sales with a Right of Return

(i) Revenue Recognition Standards Under GAAP

23. The authoritative literature is clear that for an enterprise such as WOW, revenue from sales of products is recognized at the date of sale, "usually interpreted to mean the date of *delivery to customers*" (APB Statement No. 4, paragraph 1[1]) (emphasis added).

---

[1] APB Statement No. 4 provides, in relevant part: "Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measurement principle known as realization. Revenue is generally recognized when both of the following conditions are met: (1) The earning process is complete or virtually complete, and (2) an exchange has taken place. The exchange required by the realization principle determines both the time at which to recognize revenue and the amount of which to record it. ***Revenue from sales of products is recognized under***

24. Revenue recognition is additionally expanded upon in Financial Accounting Standards Board ("FASB") Statement No. 48, "Revenue Recognition When a Right of Return Exists." FASB No. 48 "specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of, *existing practice*, either by the ultimate customer or by a party who resells the product to others."

25. FASB No. 48 was clearly applicable to the K-Mart Transaction because K-Mart had a contractual right to return the merchandise "purchased" pursuant to Blanket Order No. 3. First, the so-called "stock balancing" right extended to K-Mart under Paragraph 5 of the Letter Agreement – the right to exchange any or all of the product purchased under Blanket Order No. 3 for unspecified future WOW products – *was* a right of return.[2] An additional right of return appeared in the

---

this principle at the date of sale, usually interpreted to mean the date of delivery to customers" (emphasis added).

[2] FASB No. 48 states, in relevant part, in defining the term "returns":

> The product may be returned for a refund of the purchase price, for a credit applied to amounts owed for other purchases, or in *exchange* for other products. Exchanges by ultimate customers of one item for another of the *same* kind, quality and price (for example, one color or size for another) are *not* considered returns for purposes of this statement. (emphasis added).

However, this exemption is inapplicable here. K-Mart's stock balancing rights under Blanket Order No. 3 were not limited to the exchange of one item for another of the *same kind, quality and price*. Rather, under Paragraph 5 of the Letter Agreement, K-Mart had the right to exchange *any or all* of the Blanket

provisions of Paragraphs 1 and 5 which gave K-Mart a right to "cancel" merchandise purchased pursuant to Blanket Order No. 3 if WOW failed to meet K-Mart's deadline dates for the shipment of product from the public warehouse to K-Mart's designated "ship to" points. Furthermore, Blanket Order No. 3 gave K-Mart right to change schedules or quantities at any time – a provision which K-Mart itself apparently regarded as a right of return. *See* Excerpts from the Deposition of James Tindal quoted at paragraph 47, infra. Finally, as is discussed more fully below, *all* of WOW's sales were required to be analyzed under FASB No. 48 because, ["as a matter of existing practice,"] WOW allowed its customers to "stock balance" (See Kingsborough deposition at 114). Deposition excerpts referred to herein are attached to the Declaration of Gregory C. Moore, filed herewith the exhibits in alphabetical order by name of deponent). Moreover, as both Deloitte and Mr. May have acknowledged, WOW customarily accepted returns of non-defective product from its customers. Deloitte Memorandum at ¶ I.B.2.d.; May Decl. at ¶ 21. *See* Exhibits 33, 34 and 3 [McKee Dep. Exhs. 3 and 4 and Audit Planning Memo at 27], Deloitte workpapers which acknowledge WOW's practice of "good product returns". *See also* Landversicht Declaration at ¶ 6; Forsythe Declaration at ¶¶ 5-9, 14-22, 27-29.

Order No. 3 merchandise in its warehouse or the public warehouse at December 31, 1987 for *any* other WOW products of its choosing. Thus, K-Mart had the right to exchange Teddy Bears for video games, toy guns for hand puppets. Moreover, K-Mart was not an "ultimate customer" within the meaning of the exemption.

(ii) Revenue Recognition Was Prohibited by FASB 48

26. FASB No. 48 sets forth six conditions, *all* of which must be met before revenue can be recognized on a sale when a right of return exists. These conditions are as follows:

(1) The price between the seller and the buyer is substantially fixed, or determinable.

(2) The seller has received full payment, or the buyer is indebted to the seller and the indebtedness is not contingent on the resale of the merchandise.

(3) Physical destruction, damage, or theft of the merchandise would not change the buyer's obligation to the seller.

(4) The buyer has economic substance and is not a front, straw party, or conduit, existing for the benefit of the seller.

(5) No significant obligations exist for the seller to help the buyer resell the merchandise.

(6) A reasonable estimate can be made of the amount of future returns.

The K-Mart Transaction failed to satisfy Condition No. 3 – the requirement that revenue cannot be recognized unless "physical destruction, damage or theft would not change the buyer's obligation to the seller." Indeed, the K-Mart Letter Agreement *expressly* provided that the risk of loss due to theft, physical destruction or damage to the goods *would not* pass to K-Mart until the goods were delivered

to K-Mart's stores or warehouses. Thus, as long as the Blanket Order No. 3 merchandise remained in the public warehouse, K-Mart did *not* bear the risk of loss due to theft, physical destruction or damage. Even if K-Mart subsequently placed a "distribution order" requesting the delivery of some or all of the goods, the risk of loss would remain with WOW while the goods were in transit to K-Mart.

27. In other words, under the Letter Agreement, if any of the goods which had been purportedly "sold" to K-Mart and were sitting in the public warehouse or were in transit to K-Mart were stolen, destroyed or damaged, *K-Mart was relieved of its obligation to pay for them.* Therefore, Condition No. 3 of FASB No. 48 was *not* satisfied and FASB No. 48 prohibited the recognition of revenue in connection with the K-Mart Transaction.[3]

28. The K-Mart Transaction also failed to meet Condition No. 6 of FASB No. 48 – that "[a] reasonable estimate can be made of future returns." K-Mart's so-called "stock balancing" right was unlimited in scope and encompassed an extremely long period of time. Under the Letter Agreement, K-Mart could exchange any and all WOW products "purchased" pursuant to Blanket Order No. 3 for any other products marketed by WOW as late as July, 1988. K-Mart was not obligated to decide whether to exercise that right, and WOW would not know whether

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[3] For that reason, the statement in the May Declaration, at ¶ 10, that "there is nothing in the accounting literature that prohibits revenue recognition merely because the seller retains custodial risks" (defined as risk of *physical loss* or *damage* to the goods) is wrong.

or not K-Mart intended to do so, until January, 1988. Moreover, the right of return was not limited to defective products – it encompassed non-defective products as well. It was foreseeable that K-Mart would attempt to exchange whatever WOW merchandise it had been unable to sell its customers by December 31, 1988. However, there was no reliable basis for computing what K-Mart's "sell-through" of these WOW products would be. Therefore, there was no way for WOW or Deloitte to estimate K-Mart's future returns of product pursuant to the Letter Agreement.

(b) Revenue Recognition Was Improper Under GAAP Because the K-Mart Transaction Failed to Satisfy the Conditions Imposed by the SEC for the Recognition of Revenue on "Bill and Hold" Transactions

(i) SEC Authority Regarding "Bill and Hold" Transactions

29. The Securities and Exchange Commission ("SEC") has identified a category of transaction called a "bill and hold transaction" as to which public companies and their auditors are required to exercise special care in determining whether revenue recognition is appropriate. In a case arising out of the financial statements and practices of the toy manufacturer Mattel, Inc., the SEC stated:

> 'Bill-and-hold' generally is a practice whereby a customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment to designated locations.

In the Matter of Arthur Andersen, & Co., SEC Release No. 17878, 1981 SEC Lexis 1239 at *7 n.1 (1981) (Exhibit 7). In *Arthur Andersen, supra*, the SEC found that revenue had been improperly recognized by Mattel, with the approval of its auditor, Arthur Andersen, through "bill and hold" transactions.

30. Five years after its *Arthur Andersen* opinion, the SEC reiterated its position with respect to "bill-and-hold" transactions. *In the Matter of Stewart Parness*, SEC Release No. 23507, 1986 SEC LEXIS 1051 (1986) (Exhibit 8). In *Parness*, the SEC clearly identified the specific requirements that a "bill and hold" transaction must meet in order for revenue recognition to occur. These are as follows:

> (1) The risks of ownership must have passed to the buyer;
>
> (2) The customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation;
>
> (3) The buyer, not the seller, must request that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
>
> (4) There must be a fixed schedule for delivery of the goods. The date of delivery must be reasonable and must be consistent with the buyer's business purpose (*e.g.*, storage periods are customary in the industry);
>
> (5) The seller must not have retained any specific performance obligations such that the earning process in not complete;

(6) The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders;

(7) The equipment must be complete and ready for shipment.

Parness, supra, 1986 SEC LEXIS 1051 at *27-*30.

(ii) SEC "Bill and Hold" Authority Prohibits Revenue Recognition With Respect to the K-Mart Transaction

31. Under the SEC's "bill and hold" decisions, revenue recognition was improper for the K-Mart Transaction. The K-Mart Transaction was a "bill and hold" transaction in that it was a transaction in which "the customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment to designated locations." *Arthur Andersen, supra,* 1981 SEC LEXIS 1239 at *7 n.1. The fact that the K-Mart goods were stored in a California public warehouse paid for by WOW rather than in WOW's own warehouse makes no difference to the categorization of the transaction as a "bill and hold". GAAP requires that financial statements reflect the substance of transactions rather than the form (APB Statement No. 4 ¶ 25).

32. Analyzed under the standards set forth by the SEC for "bill and hold" transactions, the K-Mart Transaction fails the test of revenue recognition. The following chart illustrates that conclusion:

Primary Factors Mandated for Consideration by the SEC	The K-Mart Transaction.
a. The risks of ownership must have passed to the buyer.	a. By the explicit language of the Letter Agreement, the risks of theft, physical damage and destruction of the merchandise *did not* pass to K-Mart at the time of the "sale".
b. The customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation.	b. K-Mart did not make an unequivocal, fixed purchase commitment. The Letter Agreement gave K-Mart extremely liberal rights of "stock balancing"; entitled K-Mart to change the quantities purchased at will; and authorized K-Mart to "cancel" merchandise subject to the order if WOW did not timely perform certain post-"sale" duties.

c. The buyer, not the seller, must request that the transaction be on a "bill and hold" basis. The buyer must have a substantial business purpose for ordering the goods on a "bill and hold" basis.

c. WOW, not K-Mart, proposed the transaction and suggested that it be on a "bill and hold" basis.*[4]

(*Please see footnote[4] below.)

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[4] A WOW letter dated March 5, 1987, to Jim Tindal of K-Mart Corporation, documented the initial discussions with respect to the March 28, 1987 K-Mart transaction. The letter states: "As we discussed, WOW has a unique opportunity for K-Mart." On March 20, 1987, Mr. Tindal, in a memorandum to Mr. Sculley, of K-Mart Corporation, summarized the transaction as proposed by WOW. This letter was produced by WOW with various correspondence with K-Mart regarding the March 1987 transaction. Mr. Tindal stated that WOW had offered the following with respect to the K-Mart transaction:

"(1) Store goods in a public warehouse at *their expense* to be drawn into our distribution centers as merchandise is needed.

(2) Items that will be carried over into 1988 that remain in the public facility after December 31, Worlds of Wonder will continue to pay the warehouse cost . . . "

The letter also indicated that the merchandise subject to the K-Mart Transaction represented K-Mart's entire projected usage of the enumerated WOW products for 1987. See Exhibit 51.

Additional evidence supports the conclusion that the K-Mart Transaction was proposed by WOW, not K-mart. See pp. 52-54 from Transcript of the Deposition of James Whims; pp. 14-18 of the Deposition of James Tindal.

d. There must be a fixed schedule for the delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose for ordering the goods on a "bill and hold" basis.	d. Not only was there no fixed schedule for delivery, but K-Mart had the right to return any and all goods in its warehouse or the public warehouse at December 31, 1987, and receive other WOW products in return. Moreover, K-Mart had a right to cancel the deal as to some or all of the merchandise on stated conditions.
e. The seller must not have retained any specific performance obligations such that the earnings process is not complete.	e. WOW retained the obligations: ♦ To pay for the storage of the goods in the public warehouse; ♦ To bear the risks of theft, physical destruction or damage for goods in the public warehouse and goods in transit to K-Mart. ♦ To purchase any and all insurance on the goods, and pay the insurance premiums; ♦ To ship the goods to K-Mart's designated "ship to" point, at WOW's expense, by the dates specified by K-Mart; ♦ To pay the costs of K-Mart's return shipments of goods to WOW, in the

	event K-Mart exercised its right of "stock balancing"; ◆ To provide substitute goods if K-Mart exercised its right of "stock balancing", and to pay for the shipment of those goods to K-Mart.
f. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders.	f. Deloitte investigated to ensure (i) that the goods in the public warehouse were segregated and (ii) that there was sufficient product "on the water" to cover the portion of the K-Mart transaction that was to be shipped to the public warehouse "FOB Hong Kong." However, there is no indication that Deloitte identified *specific* FOB product "on the water" earmarked for the K-Mart transaction.
g. The equipment must be complete and ready for shipment.	g. See f. above.

33. *Parness* states that in order to qualify for revenue recognition, a transaction must meet *all* of the conditions set forth in the left-hand column above. However, in fact, the K-Mart Transaction meets few, if any, of them. Accordingly, revenue should not have been recognized on the K-Mart Transaction.

34. The May Declaration misses the point when it argues that mere characterization of the K-Mart Transaction as a "bill and hold" transaction does not, in and of itself, make revenue recognition improper. It is true that revenue may *sometimes* be recognized on a "bill and hold" transaction. However, this may *only* be done where the transaction meets the tests set forth by the SEC for such transactions in the *Parness* case. *See* ¶ 31, *supra*. Mr. May does not discuss or even refer to those tests. As shown above, when the K-Mart Transaction is analyzed in light of the SEC's standards, it is clear that revenue recognition is inappropriate.

35. Mr. May's professed reliance on the recitation in the K-Mart Letter Agreement that title to the goods passed to K-Mart on March 28, 1987 is insufficient. First, the statement that "title passed" is conclusory. It is not the sort of "competent evidential matter" that an auditor should rely on for a determination as to the substance of the transaction. The SEC in *Parness* prescribed the factors which accountants and auditors should consider in determining whether revenue recognition is appropriate for a "bill and hold" transaction. "Passage of title" is not one of them, for obvious reasons. Anyone can *claim* that "title passed," and there may be no objective way to confirm this legal conclusion. An auditor's job is to make a determination regarding revenue recognition in light of the *evidence*. Here, reliance on the assertion that "title passed" was unjustifiable in view of the substantial terms of the K-Mart transaction which were inconsistent with the conclusion that an exchange had taken place and that the earnings process had been completed – for example, the fact that risk of theft, loss or damage did not pass;

K-Mart's exceedingly liberal rights of "stock balancing", WOW's payment of warehousing expenses and insurance premiums; WOW's continuing responsibility for shipment of the goods to K-Mart pursuant to "distribution orders" and "stock balancing"; K-Mart's right to "cancel the merchandise" if distribution or stock balancing orders were delivered late; and K-Mart's right to change order quantities at any time.

(iii) The Transaction Was Not Consummated As of March 28, 1987 or Fiscal Year End

36. A further reason why revenue should not have been recognized on the K-Mart Transaction is because the transaction had not been consummated by fiscal year-end. The evidence shows that the Letter Agreement was backdated; that the material terms of the transaction were still being negotiated after fiscal year-end; and that drafts of the agreement were still being exchanged and reviewed as late as April 2, 1987 – two days after the end of WOW's fiscal year.

37. First, the K-Mart Letter Agreement makes clear that Blanket Order No. 3 *"will be issued only upon K-Mart's receipt of a signed copy"* of the Letter Agreement and associated documentation. K-Mart did not receive a signed copy of the Letter Agreement until at least April 3, 1987. Even then, K-Mart was dissatisfied with the manner in which the Letter Agreement had been signed and threatened not to go through with the deal unless the Letter Agreement was personally signed by WOW's Chairman and CEO, Donald Kingsborough. Pezzani

depo. at 346, 353, Ex. 52 [Pezzani depo. exh. 38]. There is evidence that Blanket Order No. 3 was not received by WOW's Account Administration Dept. until April 24, 1987. See Exhibit 50.

38. Paragraph 7 of the Letter Agreement itself recited, notwithstanding its purported date of March 28, 1987:

> This letter supersedes all prior communications, either written or verbal, with respect to Blanket Order No. 3, including without limitation *rough drafts dated* March 19, 1987 and *April 2, 1987.* (Emphasis added).

39. Deloitte auditors Eric Roberts, engagement partner, and Ronald Barrington, engagement manager, have testified that despite this language, they did not even attempt to look at the "rough draft dated April 2, 1987" or, indeed, *any* drafts of the K-Mart Letter Agreement. Roberts dep. at 217-18; Barrington dep. at 38:19 - 39:3[5]. Had they done so, they would have determined that the terms of the transaction between WOW and K-Mart had not been agreed to by March 28, 1987.

40. For example, on Friday afternoon, March 27, 1987, K-mart wrote to WOW to confirm the special terms of Blanket Order #3 – namely, that [a]ll products are purchased on a *sale or return* basis . . . "; and that the

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[5] The evidence shows that Baldev Madahar, WOW's Controller, faxed a copy of that draft to Eric Roberts. See Exhibit 53 [Madahar Exh No. 34]. Nevertheless, Roberts apparently decided not to read it. As Roberts stated in his deposition, "It's generally speaking, not my practice to go look at drafts and drafts and drafts." Roberts dep. at 217-18.

transaction was a "guaranteed sale."[6] Clearly, as of March 27, there were significant terms of the K-mart transaction still unresolved.

41. On March 30, 1987 (two days *after* the terms of the K-mart transaction were supposedly reached and the goods were supposedly "shipped") WOW's Chairman Donald Kingsborough sent E.J. Sculley of K-Mart a counter-proposal, requesting a response by March 31. The proposed draft agreement sent to Sculley by Kingsborough was significantly different from K-Mart's March 27 draft in that it provided for stock balancing, stated that the order was not a "guaranteed sale", provided for title to pass to K-mart on March 28, 1987 and stated that K-Mart would bear the risk of loss and all costs associated with the warehousing of the product.

42. On *April 2, 1987*, K-Mart faxed to Mr. Kingsborough a proposed draft letter agreement dated April 2, 1987, again changing significant terms of the transaction. The April 2, 1987 letter provided that "risk of loss of or damage to the merchandise will be borne by *Seller*" [i.e., WOW] until received by Buyer at its "ship to" points. It added that if "warehousing costs exceed $250,000 or $15,000/month, which ever is greater, Seller will reimburse Buyer the amount of such excess." The

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[6] A "guaranteed sale" is a sale under which the seller assures the retailer that if the retailer cannot sell the product to his customers, he has a right to return the product for credit and does not need to pay for it. Thus, a "guaranteed sale", as that term is used in the toy industry, is a sale that is not final and unconditional, since the retailer has the right to return the product if he is unable to sell it. Forsythe Decl., ¶ 17.

letter extended the stock balancing delivery date from January 31, 1988 to July 31, 1988, and deducted $500,000.00 from the price to be paid by K-Mart to WOW as consideration for early purchase and promotion. Additionally, the letter stated that Blanket Order No. 3 would be issued to WOW *only* upon K-mart's receipt of a *signed* copy of the letter. How could the final signed Letter Agreement, which has a date of March 28, 1987, have been consummated by the parties, when the draft letter itself was dated April 2, 1987 and the agreement required K-Mart receive a signed copy prior to the issuance of the Blanket Order?

43. Some time subsequent to April 2, 1987, a final Letter Agreement was prepared, issued by K-mart and signed by WOW. Subsequently, Blanket Order No. 3 was issued. As noted, the final agreement stated: "This letter *supersedes* all prior communications, either written or verbal, with respect to Blanket Order No. 3, including without limitation *rough drafts* dated March 19, 1987 and *April 2, 1987*" (emphasis added).

44. As the above-referenced documents demonstrate, many of the significant terms of the purported "March 28, 1987" K-mart transaction were not finalized until sometime after March 31, 1987. Accordingly, the transaction was *not* consummated as of fiscal year-end, and revenue recognition of the transaction in fiscal year 1987 was inappropriate.

45. Mr. May places reliance on a March 28, 1987 agreement for the timing of the transaction when he acknowledges the letter agreement was not finalized until April 1987. Mr. May does not even indicate if he reviewed

the numerous drafts of the agreements, which contain significant changes, including the *April 2, 1987 draft*. Additionally, Mr. May's reliance on the oral confirmation of the K-Mart agreement has no relevance as to the timing since Mr. Roberts apparently did not inquire as to when the transaction was consummated.

(iv) Revenue Recognition Was Improper Due To The Provisions Of Blanket Order No. 3 That Allowed K-Mart To Change Quantities Or Cancel The Order

46. Separate and apart from the above documents, which support that no sale had occurred as of March 31, 1987, the terms of the Blanket Order in and of themselves preclude revenue recognition until the goods are delivered to K-mart at their ship to points. The form of Blanket Order #3 attached to the Letter Agreement, unequivocally states that "shipping schedule and *quantities* may be changed at Buyer's discretion" and that the *order* could be *cancelled* "at Buyer's option if delivery dates not met."

47. Mr. May does not address the provisions of the Blanket Order #3 which allowed shipping schedules and quantities to be changed and had a cancellation provision. These conditions contradict Mr. May's conclusion that the risks and benefits of ownership have passed to K-Mart. Mr. May concludes that the only factor not met in determining whether an exchange had occurred in the K-Mart transaction was "custodial risk." May Decl. 10. Forgetting the fact that this statement completely contradicts FASB No. 48, May's statement clearly ignores the

conditional nature of the Blanket Order. In fact the K-Mart Blanket Order was nothing more than what it was entitled – an order, which could be changed or cancelled, and certainly *not* a transaction under which revenue should have been recognized in accordance with GAAP.

(v) Revenue Recognition was Inappropriate for the K-Mart Transaction Because It Appears Much of the Product In Question Was "Shipped" After Fiscal Year-End

48. The K-Mart Transaction was a combination of a Transfer Sale and FOB Sale. Some of the goods subject to Blanket Order No. 3 were "transferred" to K-Mart within the public warehouse at 950 Yosemite, Milpitas, California. Other product was purportedly shipped to the public warehouse FOB Hong Kong. However, an internal WOW business record appears to show that a substantial portion of the K-Mart merchandise was not even shipped from Hong Kong prior to fiscal year-end. Indeed, Exhibit 54, an August 6, 1987 memorandum from Mary Padilla of the WOW Sales Administration Department to Philip Rosenberg, the WOW National Accounts Manager who dealt with K-Mart, shows that a substantial portion of the K-Mart merchandise was not shipped until May or June, 1987. The senior accountant in charge of the Deloitte audit has acknowledged (McKee dep. at 180-82) that revenue recognition would be improper in fiscal year 1987 for any FOB shipments made after March 31, 1987. Accordingly, revenue should not have been recognized on such shipments in connection with the K-Mart transactions.

(vi) The Subsequent History of the K-Mart Transaction Supports the Denial of Revenue Recognition

49. After the K-Mart Letter Agreement was signed, both K-Mart and WOW treated the transaction as one which was not a final, unequivocal sale. As early as May 6, 1987 – barely a month after the Agreement was purportedly entered into – K-mart informed WOW that it was overstocked on Lazer Tag inventory and would like WOW to "sell off" 100,000 pieces of Lazer Tag covered under Blanket Order #3. See Exhibit 55. On August 31, 1987, Jim Whims of WOW wrote to K-Mart and stated that WOW would authorize the return of 124,996 Lazer Tag game kits worth over $4.5 million, along with other WOW products.

50. The deposition transcript of Mr. James Tindal, a K-mart buyer of dolls and plush toys during 1986, 1987 and 1988, states:

> Worlds of Wonder came to us with an early purchase agreement in 1987 that we would adjust or amend the terms we were currently working under. . . . In any agreement that we write on a blanket purchase there is a little statement right at the top that we reserve the right to adjust those quantities that we see fit, and that was in that one. But we didn't take this to Worlds of Wonder. Worlds of Wonder brought this deal to us. . . . Well, we talked about the amount versus what we had already purchased from Worlds of Wonder. I think ultimately we decided that what we had coming must be subtracted from their December 10th figures to get

> us down to the amount of product we thought we could use for the year. . . . Purchase orders will be sent by the re-buyer for each distribution center on an 'as needed' basis. This is what we told them we thought we would use. But we always reserve the right to change that dependent upon market conditions. It says so right in the contract. . . . If for some reason the product is not as hot or the consumers are not as mad for it as they were 60 days ago and has stopped selling, we always reserve the right to go back and renegotiate what quantities we will eventually end up with.

Tindal dep. at 14:15-17; 15:1-6; 24:18-23; 39:4-10; 39:13-17.

51. On or about June 3, 1987, K-mart met with WOW to revise Blanket Orders #3 and #4. In a memorandum of the meeting, Kerry MacVay of K-Mart referred to "the original Blanket Order #3 which was to be purchased with a sale or return privilege." The document further notes that Blanket Order #3 is to be reduced to $12,379,000, *cancelling 125,000 units of Lazer Tag*.

52. On October 1, 1987, K-Mart submitted a deduction voucher for the return to WOW of $9.9 million of "Good Product Return Stock Balancing, Adjustment Per Terms of Blanket Order No. 3." The document was countersigned by Mark Bradlee of WOW.

53. In conclusion, the K-mart Blanket Order #3, which incorporated the March 28, 1987 letter agreement, was nothing more than an expression of K-Mart's intention to purchase product which, as noted above, was subject to change and/or cancellation. GAAP requires

that the substance, not the form, of a transaction control the accounting for the transaction. *Based upon the above facts and circumstances, there was no basis under GAAP or the SEC guidelines which would allow revenue to be recognized on the K-mart Blanket Order as of March 31, 1987.*

(3) Deloitte's Audit of the K-Mart Transaction Failed to Meet the Standards of GAAS

54. Deloitte's audit of the K-Mart Transaction was reckless, grossly deficient and fell far short of the standards imposed by GAAS. In its audit of this transaction, Deloitte violated the following applicable GAAS principles – Deloitte failed to maintain an independent mental attitude, failed to obtain sufficient competent evidential matter, failed to insist that WOW's financial statements be presented in accordance with GAAP, did not exercise due professional care. Deloitte failed in its duties in the following ways, among others:

(a) It is axiomatic in the auditing field that significant transactions with unusual terms at or near fiscal year-end merit special scrutiny because they present a particular danger of errors and irregularities. Deloitte recognized the K-Mart Transaction as a "high risk" transaction, but failed to treat it with appropriate thoroughness, independence and professional skepticism. Indeed, WOW personnel have testified that Deloitte *approved* the terms of the deal before it was finally entered into. Circumstances, such as, "the completion of unusual transaction at or near year end; . . . the Company does not

correct material weaknesses in internal accounting control that are practicable to correct; . . . the accounting and financial functions appear understaffed, resulting in a constant crisis condition and related loss of controls" (AU Section 327.08 - .10) are all specifically set forth in GAAS as examples "that may lead the auditor to question whether material errors or possible irregularities exist" and "may cause the auditors to be concerned about the possibility that management may have made material misrepresentations or overridden internal control procedures (AU Section 327.10)." Furthermore, "the auditor should be aware of the importance of management's integrity to the effective operation of internal accounting control procedures and should consider whether these are circumstances that might predispose management to misstate financial statements" (AU Section 327.08 - 327.10). All of the above red flags existed at WOW. Moreover, Deloitte had knowledge of all of these circumstances.

(b) Deloitte exhibited a glaring lack of professional skepticism in auditing the K-Mart Transaction given that Deloitte identified the following special audit risk relating to WOW, as set forth in a preliminary audit planning memorandum: "The Company's ability to meet publicly stated revenue and earnings projections appears unlikely. *Management appears willing to undertake unusual and potentially improper methods to maximize sales*" (emphasis added). The memorandum further states: "Second and third quarter cut off problems resulting from tremendous volume of quarter end shipments were noted during our quarterly reviews. Top management views sales and earnings figures as extremely important." The

preliminary audit planning memorandum was produced from WOW's files. The fact that WOW was apparently provided with a copy of this preliminary memorandum for its review is itself an indication of inappropriate conduct by Deloitte, considering the planning document contains *detailed* audit procedures with respect to each audit area. Specifically for the "high risk" area of accounts receivable, it identifies detailed audit procedures, including tests of sales cutoff and confirmation procedures. In my opinion, it was inexcusable and reckless to provide the audit client with a map of the planned audit procedures. An audit is required to be independent of the client. By disclosing to the client planned procedures, all the elements of independence and professional skepticism are removed.

(c) In a memorandum analyzing the K-Mart Transaction, the auditors acknowledged that the transaction incorporated an exchange privilege and that the requirements of FASB No. 48 were analyzed in order to determine if the principle of realization had been met.[7] However, Deloitte's "analysis" made a mockery of the risk of loss provision of FASB No. 48. The auditors ignored the explicit language of the Letter Agreement to the effect that WOW would bear the risk of loss of the goods while in the public warehouse or in transit to K-mart. They chose not to face the fact that upon theft,

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[7] It appears that while Deloitte considered the criteria set forth in FASB No. 48, Deloitte believed that the requirements of FASB No. 48 did not apply to stock balancing. This is simply incorrect. As set forth previously, the stock balancing right given to K-Mart was unequivocally a right of return covered by FASB no. 48.

destruction or damage to the product, K-Mart *would not* be obligated to pay for it – a consideration fatal to revenue recognition under FASB No. 48. Rather, the auditors held that FASB No. 48's "risk of loss" requirement was satisfied because WOW had purchased insurance on the warehoused product. Therefore, the auditors concluded, *the insurance company* bore the risk of loss. This conclusion was utterly irrelevant. First, the existence of insurance was irrelevant to the determination of whether the earnings process had been completed and equally irrelevant to whether loss of or damage to the product would affect K-Mart's payment obligations – a condition which FASB No. 48 required the auditors to consider. Furthermore, the auditors apparently never even asked to look at the insurance policy in question. Barrington dep. at 84-85; Roberts dep. 296-298.

(d) The auditors determined that the K-Mart Transaction met some characteristics of a "bill and hold" transaction, but never tried to "classify" the transaction as a "bill and hold". Roberts dep. at 234-245. The auditors acknowledged that the only difference between the K-Mart Transaction and a classic "bill and hold" transaction was that the goods, instead of being sent to *WOW's* warehouse after the "sale", had been sent to *a public warehouse paid for by WOW*. Roberts dep. at 234-245; Barrington dep. at 63-66. Yet, the auditors failed to recognize that this distinction was merely a matter of form, not substance. Although Deloitte's engagement partner, Eric Roberts, was aware that there was SEC authority with respect to the proper treatment of "bill and hold" transactions, none of the auditors read that authority. Roberts Dep. at 245-247. Rather, Roberts limited his research to an internal Deloitte memorandum

which predated the publication of the SEC's *Parness* opinion – the opinion which sets out specific requirements for the recognition of revenue on a "bill and hold" transaction. The material Roberts reviewed sets out a different test for revenue recognition than the test mandated by *Parness*. Moreover, the auditors failed to adequately consider any of the factors which are decisive to a determination of whether revenue can be recognized on a "bill and hold" transaction – *e.g.*, which side proposed the transaction; whether K-Mart had a "compelling" business purpose in having the product stored by WOW instead of being shipped; whether the risks of ownership had passed to K-Mart; or whether WOW had continuing obligations after the "sale". In short, Deloitte completely failed to conduct a prudent or reasonable "bill and hold" analysis.

(e) Deloitte failed to perform the elementary investigative work to determine that the transaction had in fact been consummated before fiscal year-end. In the face of unmistakable evidence that there was a "rough draft" of the Letter Agreement dated after fiscal year end, the Deloitte auditors nevertheless unquestioningly accepted management's representation (a management that Deloitte knew was "willing to undertake unusual and potentially improper methods to maximize sales") that all of the "significant" terms of the agreement had been agreed to before fiscal year end, and never asked or even considered which terms were "significant" and which terms were not. Even though WOW's Controller sent Eric Roberts a copy of the April 2 draft Letter Agreement, Roberts either didn't take the obvious step of reading it to test management's representation that all of

the "significant" terms of the K-Mart Transaction had been agreed to prior to March 31, 1987, or read it and ignored it.

(f) Finally, Deloitte's efforts to "confirm" the K-Mart transaction were not calculated to elicit information Deloitte needed to know about the transaction. Eric Roberts had a conference call on April 3, 1987 with WOW President Angelo Pezzani and a person who represented herself to be K-Mart attorney Nancy LaDuke. However,

(i) Roberts had already decided to approve the K-Mart Transaction and had told WOW President Angelo Pezzani that he was satisfied that revenue could be recognized on it *before* he talked with Ms. LaDuke. Pezzani Dep. at 242.

(ii) Roberts did not confirm the *amount* of WOW's receivable from K-Mart at fiscal year end, or that any amount was in fact owing;

(iii) Roberts accepted Ms. LaDuke's assurance that the terms of the K-Mart Transaction were "K-Mart's normal terms for sales such as this with toy companies," without inquiring or even considering whether there were *any* "sales such as this" between K-Mart and other toy companies.

(iv) Roberts never asked Ms. LaDuke any questions designed to illuminate the requirements of FASB No. 48 or SEC "bill and hold" authority.

(v) There is no indication that Roberts sought or obtained any information regarding the date on which the Letter Agreement had been signed

or the date that Blanket Order No. 3 had been issued. Indeed, had he so inquired, he would have learned that an appropriately signed copy of the Letter Agreement *had not* yet been received and that the Blanket Order had not yet been issued.

(vi) The telephone call did not change the written terms of the transaction, under which revenue recognition was inappropriate.

55. In short, Deloitte approached this transaction with a complete lack of independence, judgment and skill, and with an apparent determination to endorse revenue recognition of the transaction regardless of the dictates of GAAP and without performing the investigation required under GAAS. Deloitte's audit work on the K-Mart Transaction was, at a minimum, reckless. Moreover Deloitte apparently approved the terms of the deal before WOW entered into it, thus substantially and knowingly assisting WOW in its preparation and dissemination of false and misleading financial statements.

C. Other FOB and Transfer Sales

1. Introduction

56. In total, including the K-Mart Transaction, WOW recognized revenue of $16.8 million and $15.1 million on dated FOB and Transfer Sales, respectively at March 31, 1987. These transactions were, in essence, "bill and hold" sales, as was previously defined. The transactions involved the "transfer" of WOW's existing inventory at March 1987, from WOW's inventory to inventory

segregated and marked as the customers; and the recording as a sale of merchandise in-transit from suppliers in the Orient to WOW - US.

57. In my opinion, it was improper under GAAP for WOW to recognize revenue in connection with the dated FOB and Transfer Sales. The issue is not even a gray area. Moreover, Deloitte's audit work on the FOB and Transfer sales failed to satisfy GAAS. No reasonable informed auditor, knowing what Deloitte knew about the FOB and Transfer Sales, would have rendered an unqualified opinion on WOW's fiscal 1987 financial statements. Of the $31.9 million of sales under these two programs, the K-Mart transaction comprised $16.4 million. In addition to the reasons set forth in the K-Mart section, the following sections will provide additional reasons for my opinion that revenue recognition was improper.

2. Revenue Recognition was improper under GAAP and SEC Authority

58. The transactions in general failed to meet the following criteria necessary before revenue and earnings could be recognized:

(a) The condition that physical destruction, damage, or theft of the merchandise would not change the buyer's obligation to the seller.

(b) That a reasonable estimate of the amount of future returns and allowances could be determined at March 1987.

(c) The FOB and Transfer Programs were instituted by WOW in order to enhance sales,

and the customers did not have a compelling business purpose to request a bill and hold transaction.

(d) Risk of ownership did not pass to the buyer of the goods.

(e) These programs modified WOW's normal billing and credit terms for these buyers.

The following sections discuss two particular FOB and Transfer Program transactions, in support of my opinions.

3. Wal-Mart Transactions

59. In March, 1987, WOW recorded in excess of $6 million of revenue from purported Transfer Sales and FOB Sales to Wal-Mart Stores, Inc. The Wal-Mart revenue recorded at March 31, 1987, under the FOB and Transfer sales was, in itself, material to WOW's fiscal year and fourth quarter ended March 31, 1987 reported earnings. WOW reported earnings before taxes of approximately $2.0 million on the Wal-Mart Transactions, or approximately 7% of reported fiscal year 1987 earnings before taxes.

60. In my opinion, it was improper under GAAP for WOW to recognize revenue in connection with the Wal-Mart Transactions in fiscal year 1987. Again, if one applies GAAP and the principles of fair presentation, the issue is not even subject to debate. Furthermore, Deloitte's audit work regarding the Wal-Mart Transactions was reckless, since Deloitte reviewed the very documents which preclude revenue recognition at March 31,

1987, and yet passed upon the transactions. In the following paragraphs, I explain the reasons for my opinions.

(a) Terms of the Wal-Mart Transactions

61. To determine the impropriety of recognizing revenue on the Wal-mart FOB and Transfer Sales at March 31, 1987, one need only review the actual purchase orders issued by Wal-mart with respect to these sales – a procedure purportedly performed by Deloitte in conjunction with its audit procedures at March 31, 1987. The actual purchase orders issued by Wal-mart were dated April 1, 1987, with a cancel date of April 13, 1987. Both purchase orders contained the following language: "Wal-mart reserves the right to *change or cancel orders at any time*" (emphasis added). Additionally, one of the purchase orders, for approximately $1.4 million of product, contains the following language: "Sales in transit to U.S.; Seller agrees on behalf of Buyer to obtain and be responsible for payment of all transportation freight, insurance (marine, or risk, and inland) and U.S. customs duty changes for delivery to alternative destination specified on P.O. (including arranging for the independent quality check of the merchandise), with Seller to *retain* security interest in the merchandise until such delivery (emphasis added)." Indeed, this was standard language for purchase orders under WOW's March, 1987 FOB program.

(b) Under GAAP, Revenue Should Not Have Been Recognized on the Wal-Mart Transaction

62. The Wal-Mart Transactions fail to meet the most basic of revenue recognition criteria, as set forth in APB Statement No. 4 and FASB Statement of Concepts No. 5. No exchange had occurred between WOW and Wal-Mart at March 31, 1987. Wal-Mart purchase orders clearly and simply state that "Wal-Mart reserves the right to *change* or *cancel* orders at *anytime*" (emphasis added). The product was *not* accepted by Wal-Mart as of March 31, 1987 and, in fact, had *not* even been delivered to the customer as of that date.

63. Supporting Wal-Mart's right to cancel the above *orders* was the fact that WOW issued credit memos in April 1987 for approximately $900,000 for Wal-Marts refusal to accept these "sales." Additionally, in my review of the bills of lading associated with these Wal-Mart Transactions, I noted that the product was not shipped to Wal-Mart until mid to late April 1987.

64. In addition to the $6.0 million of sales recorded under the FOB and Transfer Sales Programs to Wal-Mart, WOW recorded revenue of $1.8 million on Lazer Tag product with extended payment terms until December 10, 1987. The purchase with respect to the Lazer Tag product contained the same language regarding the cancelable nature of the order, and in fact in April 1987 Wal-Mart refused to accept 10,000 units – approximately $361,000 – of this product, or 20% of the shipment.

65. Supporting the fact that a sale did not occur as of WOW's fiscal year end March 31, 1987, for the above

transactions with Wal-Mart is correspondence from WOW's sales representative for Wal-Mart indicating that a "non-existent" purchase order was created for WOW to record revenue at March 31, 1987. See Exh. 56. Additionally, letters from Tartan Sales Company dated in May 1987 show that WOW was responsible for paying the storage charges of Wal-Mart product at the public warehouse. Exhs. 57 and 58. A letter dated June 11, 1987, from Tartan Sales Company, to WOW, states the following: "At the end of WOW's 1986 [March 31, 1987] fiscal year, we put a tremendous push on orders to Wal-mart. The actual purchase orders were never received until April. In order to meet WOW's deadlines, a non-existent purchase order was given that was to be replaced by the hard copy P.O." Exh. 56.

66. Revenue recognition was improper under GAAP because the Wal-Mart transaction failed to satisfy the conditions imposed by the SEC for the recognition of revenue on "bill and hold" transactions. As noted in my analysis of the K-Mart Transaction, the SEC has set forth specific criteria that must be considered before revenue can be recognized on a "bill and hold" transaction. In substance, the Wal-Mart FOB and Transfer Sales were "bill and hold" transactions. The merchandise was still under the physical control of WOW regardless of its being stored at a public warehouse or in transit to WOW.

67. The following analysis utilizing the standards set forth by the SEC illustrates how the Wal-Mart Transactions failed to meet the test of revenue recognition:

(1) Contrary to having made a fixed commitment to purchase the goods, Wal-Mart issued purchase orders which allowed cancellation at anytime.

(2) Contrary to the requirement that the risks of ownership must have been passed to the buyer, WOW retained a security interest in the goods until delivery to Wal-Mart.

(3) Contrary to the requirement that the seller not retain any specific performance obligations, WOW retained the obligation of paying for the storage of the goods at the public warehouse[8], the obligation of delivery of the goods to customer's ultimate location, and the obligation of insuring the goods until delivery of goods to customer's ultimate destination.

68. In conclusion, the Wal-Mart Transactions were nothing more than purchase orders issued subsequent to WOW's fiscal year ended March 31, 1987, which, as noted above, were subject to change and cancellation. The goods had *not* been shipped to Wal-Mart as of March 31, 1987, *nor* did Wal-Mart have a fixed obligation to purchase the goods at March 31, 1987. There was no basis under GAAP which would allow revenue to be recognized on the Wal-Mart Transactions.

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[8] Tartan Sales Company documents, sales representative of WOW, dated in April and May 1987 indicate that Western Distribution Center was attempting to bill Wal-Mart for storage charges. As Mike Needleman of Tartan writes to WOW: "Wal-Mart is still receiving bills from this warehouse. They have no intention of paying for the storage of our software. These bills are annoying to their buying staff." Exhs. 57 and 58.

(c) Deloitte's Audit of the Wal-Mart Transactions Failed to Meet of Standards of GAAS

69. Deloitte's audit of the Wal-Mart Transactions was reckless, grossly deficient and fell short of the standards imposed by GAAS. In its examination of these transactions, Deloitte violated the following GAAS principles – Deloitte failed to obtain sufficient competent evidential matter, failed to exercise due professional care, and failed to insist that WOW's financial statements comply with GAAP. Deloitte failed in its audit in the following ways, among others:

(1) Deloitte purportedly looked at the Wal-Mart purchase orders dated April 1, 1987, which were subject to change and cancellation, to verify the propriety of revenue recognition at March 31, 1987. On their face, the purchase orders did not support revenue recognition, and yet Deloitte did not question the recognition, or perform any additional procedures.[9]

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[9] Ronald Barrington, Deloitte engagement manager, testified: A. With regards to the purchase orders, really, all I can tell you is what I can read here as far as what he did, which is examine the purchase order and extend it and footed it.
Q. So if Wilson saw the following language on the purchase order, language that appears on purchase order No. 0220072048 in the central column, if you saw the following language, "Wal-Mart reserves the right to change or cancel orders at any time," you didn't understand that he would bring that to anyone's attention in connection with the audit; is that correct?
A. I would think he would bring it to somebody's attention for consideration. (Barrington Dep. at 302: 8-20)

(2) Deloitte failed to test if the Wal-Mart Transactions met the criteria for revenue recognition on a "bill and hold" transaction. In fact, there is no evidence that Deloitte even considered the criteria the SEC had set forth for revenue recognition on "bill and hold" transactions.

(3) Deloitte failed to test whether the Wal-Mart Transactions met the criteria set forth in FASB No. 48 for revenue recognition.

(4) Deloitte failed to review for subsequent credit memos issued in April 1987 related to the purported March 1987 transactions.

(5) Deloitte did not test for shipment of the goods to Wal-Mart or their acceptance thereof.

(6) Deloitte failed to request from customers, as a significant part of its FOB and Transfer Program audit procedures, a confirmation of the customers' receivable – the balance owing to WOW as a result of a sale transaction at March 31, 1987. What Deloitte did confirm was the customers' *purchases* from WOW[10]. It is completely and utterly irrelevant to confirm a customer's purchases, when the audit procedure is designed to validate the assertion that a revenue transaction has occurred resulting in a customer receivable. In

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[10] Ronald Barrington testified as follows:

Q: Worlds of Wonder has not here asked Wal-Mart to confirm the receivable, has it?

A: We've asked him to confirm the purchase.

Q: And not the receivable, right?

A: From a reading of the letter, I would say it's the purchase. (Barrington dep. 277:1-10)

accounting terms of art, a purchase represents only a commitment on the behalf of the customer to order product from WOW. The fact that a customer confirms that they have placed purchase orders with WOW does *not* provide Deloitte with any verification that a sale has occured or that the customer acknowledged the receivable at March 31, 1987.

(d) Gold Circle Transactions

70. Two letters written by WOW's sales representatives to Gold Circle summarize the actions taken by WOW to overstate its revenues and earnings at March 31, 1987. A letter dated January 15, 1988 states:

> [Gold Circle was] asked by us to do many 'favors,' and take most of their yearly purchases in January, February, and March. They sat on this product all year while the retail prices eroded. They were never comfortable with this situation, but they trusted us.

71. Furthermore, on July 19, 1988, Brennan & Howard, Inc. outlines in a letter how WOW had requested Gold Circle to provide favors to WOW and that WOW would not let them "get hurt." In substance, a term utilized by WOW for a consignment sale.

> Basically, prudent buying practices were set aside at Mr. Kingsborough's request for 'favors' to help W.O.W. make their sales plans. To cite only one example, Gold Circle decided to buy three containers under the 'container' program. I submitted the orders. After numerous phone calls from Don Kingsborough and Jim Whims, and assurances *that they would not let Gold Circle*

> *'get hurt,'* the orders were increased to 8 containers. This product was bought based on Gold Circle's confidence in Don and Jim, personally. We found out later that this was more product that most major national accounts, many times bigger than Gold Circle, ever took in. The 5 additional containers are essentially the overstock problem which is creating the current impasse. (emphasis added).

I have reviewed the Declaration of Pat Landversicht of Brennan Howard, which I understand is being filed with the Court herewith. That declaration confirms the accuracy of the January 15 and July 19 letters referred to above.

72. Gold Circle purchased approximately $1.4 million of product under WOW's December 10th Dating Programs. The quantities shipped to Gold Circle – well in excess of their normal requirements – in conjunction with the extended dating terms, created a situation in which WOW could not reasonably estimate returns[11] and/or other concessions, such as price protection, that would have to be issued in the future to help "sell through"

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[11] FASB No. 48 states:
However, the following factors may impair the ability to make a reasonable estimate:

a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand.
b. Relatively long periods in which a particular product may be returned.
c. Absence of historical experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers.

product. Therefore, under GAAP, revenue recognition could not occur at March 31, 1987.

73. In summary, Deloitte failed to document any audit procedures designed to determine whether sales under WOW's FOB and Transfer Programs, other than K-Mart, such as those to Wal-Mart and Gold Circle, met the revenue recognition criteria established in FASB No. 48 and the SEC with respect to "bill and hold" transactions. These transactions were required to be evaluated in terms of the criteria established in FASB No. 48 due to WOW's stated or implicit practice of allowing product to be exchanged for stock balancing, and "good product" returns. As noted previously, in order for revenue recognition to be appropriate under GAAP, a transaction must meet *all* the criteria set forth in FASB No. 48. The fact that WOW retained the risk of physical destruction, damage, or theft of the merchandise, in itself, precluded revenue recognition. The failure to be able to reasonably estimate returns at March 31, 1987 precluded revenue recognition. Deloitte's failure to test these transactions for compliance with FASB No. 48 and the SEC conditions demonstrates its reckless disregard of due professional care and lack of sufficient competent evidential matter to support its opinion.

D. Barter Transactions

74. During March 1987, WOW entered into agreements with two barter brokers – Deerfield Communications Corporation and Admerex International, Inc., whereby WOW transferred product to these brokers in exchange for *future* advertising media credits. As a result

of these transactions, WOW recorded revenue of *$9,054,000* and earnings before income taxes of *$5,668,000,* at March 31, 1987. These two transactions represented *19.6%* of WOW's reported earnings before taxes at March 31, 1987.

1. Under GAAP, Revenue Should Not Have Been Recognized on the Barter Transaction

75. In my opinion the recognition of revenue on these transactions was improper and contrary to GAAP for the following reasons:

a. The advertising credits received in the exchange by WOW were *contingent* and *conditional* upon WOW purchasing future advertising time through the brokers. Both agreements merely provided for *discount credits* on *future* media time purchases; and

b. The utilization of WOW's standard sales price of the *discontinued* product exchanged for the advertising media credits overstated WOW's revenue and earnings on the transactions. The transactions should have been recorded at the estimated realizable value of a cash transaction, involving the sale of the discontinued product, not at the inflated normal sales price of the goods as was done.

(1) Revenue Should Not Have Been Recognized on the Barter Transaction Because The Transactions Fail to Meet GAAP's Requirements for a Completed Transaction

(a) Revenue Recognition Standards Under GAAP

76. FASB No. 5, "Accounting for Contingencies," reiterates Accounting Research Bulletin No. 50 with respect to the accounting for a gain contingency. It states: "Contingencies that might result in gains usually are *not* reflected in the accounts since to do so might be to recognize revenue prior to its realization." Furthermore, a contingency is defined as "an existing condition, situation, or set of circumstances involving *uncertainty* as to a possible gain . . . to an enterprise that will ultimately be resolved when one or more *future* events occur or fail to occur" (emphasis added). FASB Statement of Concepts No. 5 states that two factors are required *before* revenue can be recognized, "(a) being realized or realizable and (b) being earned." It further states: "Revenues and gains are realizable when related *assets received* or held are *readily* convertible to known amounts of cash or claims to cash." Additionally, it requires that, when assets are exchanged, revenues may be recognized provided they have been earned *and* the transaction is *completed*. Recognition of revenue depends on the requirement that the fair values involved can be determined within reasonable limits.

(b) The Transactions Involved Contingent Future Media Time

77. The advertising media credits were only realizable if WOW: (a) purchased through the barter broker the advertising time available through the broker's vendors, (b) paid the cash portion required by Deerfield and Admerex to utilize the credits, and (c) utilized the credits prior to the expiration date of the agreements. The Deerfield agreement required WOW to pay in cash between 50% to 90% of the media goods or services available to WOW, with the balance being paid through utilization of the credits. The credits expired in 36 months. The Admerex agreement contained similar provisions. Neither agreement provided WOW with guaranteed media time in certain geographic regions or time slots.

78. Due to the fact that barter transactions are common to the broadcast industry, the authoritative literature with regards to accounting practices in the industry, FASB No. 63 "Financial Reporting by Broadcasters" contains a specific section on barter transactions. For an accountant or auditor not to review the authoritative literature dealing with barter transactions in the broadcast industry, when one is auditing in a barter transaction involving media advertising time, would be reckless. In reviewing the propriety of the accounting for a financial transaction, it is common, appropriate, prudent and required by GAAS to review the accounting literature for analogous situations.[12] It would be impossible for the authoritative

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[12] AU Section 411.08 specifically states:

The auditor *should be* familiar with alternative accounting principles that may be applicable to the

literature to cover all situations or transactions encountered in practice.

79. FASB No. 63 states: "Barter revenue shall be reported when commercials are broadcast, *and* merchandise and services received shall be reported when *received* or used" (emphasis added). This requirement is set forth to comply with FASB No. 5, as noted above, in accounting for gain contingencies. An enterprise must have earned the revenue (broadcast the commercial) *and* the revenue must be realized (goods or services received). In applying the same criteria to WOW's barter transactions, WOW earned the revenue (transferred the goods to Deerfield and Admerex), but the revenue was *not* realized (WOW received credits contingent and conditional upon the utilization and payment of future broadcast media time), and therefore revenue recognition was inappropriate. Mr. May's declaration misses the point that the credits were contingent and under GAAP could not be recorded as revenue. Additionally, Mr. May is just plain wrong

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> transaction or facts under consideration and realize that an accounting principle may have only limited usage but still have general acceptance. On occasion, established accounting principles *may not exist* for recording and presenting a specific event or transaction because of developments such as new legislation or the evolution of a new type of business transaction. In certain instances, it may be possible to account for the event or transaction on the basis of its *substance* by *selecting* an accounting principle that appears appropriate when applied in a manner *similar* to the *application* of an *established* principle to an *analogous* event or transaction. (emphasis added)

regarding the application of GAAP to analogous transactions.

(c) The Revenue Recorded on the Barter Transactions Was Overstated

80. Furthermore, the fair value of the goods exchanged by WOW, clearly should *not* have been their normal sales price. The products were *discontinued* WOW products with poor retail sales. WOW would have had to significantly discount this product to sell it. To value this exchange at the full sales price of the WOW product exchanged defies the most basic business logic and sense. Deloitte's memorandum analyzing the transaction indicates, at a minimum, that the sales value of the product exchanged should be discounted by 15% (the amount of discount WOW would receive if it contracted directly with the networks for advertising time). While I agree with the direct buy media discount, in reality, it would result in an even greater than 15% gross revenue reduction as Deloitte noted. Since in some cases WOW was only receiving a barter discount credit of 20%, and if they could obtain a discount of 15% directly then the advertising credits only provided WOW with approximately an additional 5% discount. Therefore, the advertising credits were at most worth approximately 25% to 50% of their recorded value. This makes common sense – that since WOW was disposing of discontinued product it would only be receiving approximately 50% to 75% of its normal sales value. As noted, GAAP requires that the substance of a transaction be emphasized over the legal form in determining the appropriate accounting treatment.

(d) The Subsequent History of the Barter Transactions

81. Finally, both WOW and Deloitte knew that as of May 1987, WOW had utilized *none* of the advertising credits. In fact, as of September 30, 1987, six months subsequent to the agreements, WOW had utilized only approximately $700,000 of the advertising credits, or only about 7.7%. By December 31, 1987, WOW recorded significant write downs of the credits, due to the fact that they would never be realized.

(2) Deloitte's Audit Procedures in Connection with the Barter Transactions Failed to Meet the Standards of GAAS

82. Deloitte's audit of the Barter Transactions was reckless, grossly deficient and fell far short of the standards imposed by GAAS. In its audit procedures related to this transaction, Deloitte failed to exercise due professional care, failed to obtain sufficient competent evidential matter, failed to insist that WOW's financial statements be presented in accordance with GAAP, and failed to maintain an independent mental attitude. Deloitte failed in its duties in the following ways, among others:

(a) As previously noted, significant transactions with unusual terms at or near fiscal year end merit special scrutiny because they present a higher risk of errors and irregularities. Deloitte recognized the Barter Transactions as "high risk" transactions, but failed to treat them with appropriate thoroughness, professional skepticism and due care.

(b) In a memorandum analyzing the Barter Transactions, the auditors acknowledged that the revenue on the transactions should be discounted by 15%. The memorandum states: "WOW could contract directly with a media broker and receive such time [at a] 15% discount." The auditors ignored this minimum 15% discount when they audited the revenues on the Barter Transactions. The use of a 15% discount, in itself, would have reduced earnings before taxes by $1.35 million. Deloitte misapplied logic when it determined that a 15% media discount equated to only a 15% revenue discount. At noted previously, these advertising credits required WOW to pay a cash portion for the media time up to 80% of the cost of the media time. Therefore, since WOW on its own could receive a 15% discount the credits were only worth an additional 5% discount. Therefore the credits should have been discounted by 25% to 50%. Furthermore, the auditors completely failed to consider the contingent nature of the advertising credits. As previously noted, the advertising credits represented a gain contingency that was *not* realizable unless and until WOW used the credits within a specified time period. Deloitte fails to address the substance of the agreement – the disposal by WOW of discontinued product for the possibility of future media time discounts. There is *no* current realized benefit to WOW at March 31, 1987. The revenue should be recognized as the credits are used, thus WOW should have recorded advertising expense in an amount equal to the barter revenue – the true economic substance of the transaction.

E. PRICE PROTECTION, SALES RETURNS & INVENTORY RESERVES

83. The next three sections will address three interrelated accounting issues – price protection, sales returns and inventory reserves. The accounting and auditing failures related to these will all involve the following factors among others:

(a) The explosive inventory build-up at WOW which occurred from January through June 1987. Without a corresponding "real" (not manipulated) increase in retail demand, which translates to WOW revenue increases, the inventory build-up had disastrous financial consequences. WOW had in excess of $56 million of inventory at March 31, 1987, with another $42 million on firm purchase commitment. This amount of inventory represents, in terms of WOW's sales, approximately $160 million of revenue. These inventory levels at March 31, 1987, were in spite of all of WOW's revenue manipulations. WOW had recorded $32 million of revenue on product, some of which, would not be delivered to the customer until late 1987. WOW had asked its customers for favors to take most of their 1987 requirements for existing product by March 1987. Even after these manipulations WOW still had excessive inventory levels.

(b) WOW had only $18 million of available funds under its line of credit facility at March 31, 1987. Its accounts payable totalled in excess of $56 million at March 31, 1987. Its accounts receivable at March 31, 1987 included at least $52 million of receivables which

were not due until December 1987. WOW's trade creditors were already stretched out in excess of 60 days. WOW was in a severe *cash crisis* at March 31, 1987 which proceeded to get worse. At June 30, 1987, after raising *$80* million from the public on June 4, 1987, WOW had cash of $84,000; WOW had available bank borrowings of only $5 million; WOW's inventory had increased to $94 million; WOW's trade payables were at $47 million, now in excess of 90 days old; and WOW's sales of $23 million were lower than the prior year's comparable quarter. At June 30, 1986, WOW's inventories were $19 million versus the current $94 million. At June 30, 1987, WOW's financial position, after raising $80 million less than 30 days prior, was bleak. Additionally, a substantial amount of WOW's inventory was Lazer Tag products, a product that was experiencing poor consumer demand.

(c) WOW's major customers were overstocked with WOW's existing products and sell through on the products was poor. Indeed, as the declaration of John Forsythe states by February, 1987 I learned that "consumer demand for the Lazer Tag line had declined dramatically", and during February through May 1987 "a substantial number of customers wanted to return excess inventory of Lazer Tag products." Forsythe Decl. at ¶ 25.

(d) What were WOW's alternatives during January through June 1987? WOW had to report impressive revenue and earnings numbers in order to raise additional capital. WOW would have to reduce its prices in order to move its inventory, and WOW would have to accept returns, including stock balancing for slow moving products. These factors are the very factors that caused inventory valuation reserves to be recorded

(lower of cost or market, excessive inventories); price protection credits to be issued, a common industry practice, since WOW would have to reduce its price to stimulate demand; and sales returns to substantially increase. WOW did not have an alternative to carry the inventory until demand increased since WOW was out of cash and out of borrowing capacity. WOW had to reduce its inventory levels to generate cash flow.

(e) As an auditor, Deloitte was required to be aware of these factors. An auditor must demonstrate an awareness for not only the client's business but additionally the industry in which the client operates (AU Section 311). Deloitte was reckless and grossly deficient in not recognizing the above financial conditions at WOW. It was Deloitte's duty to understand the current financial condition of WOW in order to properly perform its audit.

The above conditions dictated the accounting for price protection, sales returns, and inventory reserves which are discussed in the following sections.

1. Price Protection

a. Introduction

84. Price protection is a practice whereby the retailer is granted credits on merchandise in its existing inventory when the manufacturer lowers the sales price of that product. As acknowledged in Deloitte's memorandum and Mr. May's declaration: "It is a common practice

in the toy industry and in other consumer goods industries to grant retailers 'price protection.' " (May Decl. ¶ 23)

b. Under GAAP and the SEC Regulations, Price Protection Should Have Been Disclosed

85. In my opinion, price protection should have been disclosed as follows:

(a) At a minimum, price protection should have been disclosed as a material contingent liability in the financial statements of WOW at March 31, 1987.

(i) FASB No. 5 "Accounting for Contingencies" requires that a loss contingency be disclosed when it is *reasonably possible* that a liability will be incurred resulting in a loss or impairment of an asset, such as accounts receivable. FASB No. 5 defines reasonably possible as: "The chance of the future event or events occurring is more than remote but less than likely." Furthermore, FASB No. 5 requires that if a loss contingency is probable ("the future events are likely to occur") and estimable then "an estimated loss contingency shall be accrued by a charge to income." Specifically relating to the disclosure of a loss contingency, FASB No. 5 states: "disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." Price protection is a liability incurred in connection with the

sale of goods. Mr. May's statement that "price protection is generally treated under GAAP as a 'period cost', or a cost that is accounted for at the time the price protection is actually given, *not* at the time the original sale is made" is misleading and is *not* in conformity with GAAP. If, at the time of sale, it is probable and estimable that price protection will be issued then a charge to income must be made for the price protection. If, at the time of sale it is reasonably possible that price protection will be issued, then the contingency must be disclosed. Additionally, if an enterprise or industry commonly offers price protection and it is more likely than not that price protection will be issued, the accrual and/or disclosure requirements of FASB No. 5 are met. Furthermore, FASB No. 5 requires that all information available before the financial statements are issued be considered in determining whether a loss contingency existed at the financial statement date.

(b) Price Protection should have been disclosed in the textual portion of the June 4, 1987, Prospectus in the business description and in the MD&A sections;

(i) The SEC in regulation S-K, item 101, requires disclosure of "the practices of the registrant and the industry relating to working capital items (e.g. . . . where the registrant provides rights to return merchandise, or where the registrant has provided extended payment terms to customers)." Item 303 requires that Management's Discussion and Analysis of Financial Condition and Results of Operations disclose: "Any known trends or uncertainties that have had or that the registrant reasonably expects will have a material

favorable or unfavorable impact on net sales or revenues or income from continuing operations." Additionally, Item 303 states: "The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) *matters that would have an impact on future operations and have not had an impact in the past,* and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations" (emphasis added).

86. The following sections show the basis for my opinions regarding disclosure of price protection under GAAP and Regulation S-K.

(a) WOW's major customers had purchased a significant amount of their 1987 inventory requirements of WOW's existing products and yet WOW's inventory level at March 31, 1987 had ballooned to in excess of $56 million from $17.7 million at December 31, 1986. Additionally, WOW had approximately $42 million in purchase commitments outstanding for additional inventory at March 31, 1987. It was extremely probable that WOW would have to discount its prices to move all of this inventory and, therefore, incur price protection credits.

(b) The extended payment and delivery terms granted to customers to "enhance" sales meant that WOW had to project what the market for its products

would be for the 9 month period, through December 1987 until customers' paid.

(c) WOW had extended formal price protection during March 1987 to Gold Circle. A March 23, 1987 letter written by Brennan & Howard, sales representatives of WOW to Gold Circle, states with respect to a March 12th meeting that "Gold Circle will receive complete price protection on all merchandise received from purchase order numbers G667846 and G668549. This will cover any circumstances in which Worlds of Wonder either lowers its dealers cost or raises its dealer discounts."

(d) As early as September 30, 1986, WOW had considered that the likelihood of its issuing price protection was probable and had accrued $587,000 as a price protection reserve. As Deloitte notes in its work papers prepared in conjunction with its second quarter review, "During 2Q87, client established a Price Erosion reserve of $587k charged to other C.O.S. This cost was recorded in anticipation of amounts which will be owed to retailers holding TRX's in inventory after Christmas when WOW drops the retail price of TRX's." Yet, no reserve was recorded at fiscal year-end March 31, 1987 when conditions in the market had significantly deteriorated.

(e) During the second quarter of fiscal year 1988 (September 30, 1987) WOW recorded price protection charges in excess of $13 million. Furthermore, during the third quarter of fiscal 1988, WOW recorded additional price protection reserves of approximately $6 million. A significant amount of these reserves related to

goods shipped to customers under the March 1987 Dating Program.

(f) Mark Bradlee, Executive Vice President of Sales, testified that price protection was a common industry practice and it was in fact provided to retailers who purchased product under the dating program. Mr. Bradlee testified that the price protection extended through the Christmas season of 1987.[13]

c. Deloitte's Audit Procedures with Respect to Price Protection Were Nonexistent

87. Deloitte did not even address the issue of price protection in its audit work papers for its March 31, 1987 examination. Additionally, during its subsequent review procedures, Deloitte failed to consider the effect of price protection on the March 31, 1987 financial statements. Deloitte's recklessness and lack of due care in not performing *any* audit procedures with respect to a common industry practice such as price protection is a strong indication of Deloitte's failure to conduct a GAAS audit.

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[13] A: Again, price protection falls into the same category of stock balancing. Within the entire trade, you will not be in business as a company if you lower your price and leave the retailers with the higher priced product. So without having it to be stated with the majority of all accounts, it's an industry standard. Some accounts require it in writing . . . but it's an industry standard.
Q: Did the Company, in fact, provide price protection for any of the customers who bought under the extended payment program between the time the goods were shipped and the Christmas season?
A: Yes. Bradlee dep. at p. 202.

88. Deloitte's failure to consider the effect of the practice of price protection on the March 31, 1987 financial statements was an extreme departure from GAAS for the following reasons:

(a) Deloitte knew or should have known that price protection was a common industry practice.

(b) Deloitte had knowledge that WOW had recorded a liability for price protection in prior financial statements.

(c) Deloitte knew that WOW's inventory levels had skyrocketed at March 31, 1987 and had continued to increase through June 1987. Deloitte knew that this inventory increase was in spite of WOW's improper "sales" programs designed to inflate fiscal 1987 sales. Deloitte knew that WOW had approximately $42 million of inventory on firm purchase commitments at March 31, 1987.

(d) Deloitte failed to inquire of any FOB or Transfer sale customers whether price protection terms were included in the terms under which the goods were "sold" to them.

(e) Deloitte knew that the K-Mart agreement, Blanket Order #3, specifically provides for price protection

under the stock balancing provision. Mr. May improperly interprets this language as providing K-Mart with risk of market decline. However, in reality, it does just the opposite. The provision requires WOW to provide stock balancing goods to K-Mart at the lower of WOW's existing prices or WOW's prices at March 28, 1987. At a minimum, Deloitte failed to confirm the stock balancing and price protection clauses with K-Mart.

2. Sales Returns and Allowances

a. Introduction

89. A provision/reserve for sales returns and allowances must be established when the sale is recorded. FASB Statement No. 5 requires that any costs or losses that are expected in connection with any returns of product sold be accrued at the time of sale. If an enterprise cannot make a reasonable estimate of sales returns at the time a sale is recognized, FASB Statement No. 48 precludes revenue recognition on the transaction. In my opinion, WOW materially understated its reserves for sales returns at March 31, 1986 and 1987. In the following sections I explain the reasons for my opinion.

90. Contrary to Mr. May's declaration and Deloitte's memorandum, Deloitte was clearly aware that WOW had accepted significant "good product" returns prior to March 31 1987. Deloitte notes in its work papers prepared as a result of its review of the June 30, 1986 financial

statements that: "Beginning the 1Q87, client began accepting 'good products' returns in addition to defective returns. Significant portions of returns recorded in 1987 related to good product." In performing its June 30, 1986 review, Deloitte notes that the pre-tax effect of "good product" returns that should have been reserved for at March 31, 1986 was $761,000, or 5% of reported pre-tax income. This was based upon an estimate that 55% of good product returns received in first quarter 1987 related to sales originating in fiscal year ended March 31, 1986. Total good product returns for June 30, 1986 booked by WOW was approximately $1,844,000 – clearly a significant amount.

91. The deposition of Angelo Pezzani, President and Chief Operating Officer, confirms that WOW accepted good product returns.[14] Additionally, Mark Bradlee testified: "I would say that with every customer we ever did

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[14] Q: For how long did Worlds of Wonder have a policy of accepting good product return from customers to reduce excess product inventory?
A: Mr. Kaufmann, to the best of my recollection, we never had a specific policy, but this is what happens in the toy industry.
Q: You just do it sometimes?
A: No. What happens is, you have a customer. He orders product; you sell product to him. And he believes at certain points in time he has more inventory than he really needs, so he either starts sending the product back or he withholds payments. And what you have to do is work with the retailer to find out exactly what his problem is and work through it with him. So when you say did we have a policy, no, we didn't have a policy. If a retailer called us and said he had a problem, we didn't ignore him. We tried to work with him.
Q: And working with them included taking it back: correct?
A: When a retailer would call us and said he had excessive inventory, many times we try to work through it with him. We

business with, stock balancing is an industry – assumed practice, that you will help out a customer who has an imbalance in his stock." See also, Forsythe Decl. ¶ 15 ("A substantial number of Worlds of Wonder customers, including many of our largest accounts, were allowed to return non-defective merchandise after a valid shipment.") The authoritative literature states without qualification that the criteria of FASB 48 must *all* be met when a right of return exists, either by contract or as a matter of existing practice by the Company.

92. The following facts support my opinion that FASB No. 48 was applicable to all of WOW's sales transactions:

(a) Good product returns are common in the toy industry, and were common at WOW.

(b) WOW granted return privileges (including stock balancing) to numerous of its major customers, on a formal (K-mart) and informal basis.

(c) WOW had accepted good product returns in the normal course of business.

(d) WOW accepted in excess of $30 million of returns in fiscal year ending March 31, 1988, primarily relating to sales recorded at March 31, 1987.

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sometimes said, okay, if you're going to return this product, how about taking another product dollar for dollar? We'd try to work with him as best we could. (Pezzani dep. at 97: 3-25, 98: 1-16)

b. GAAP Requires that a Reasonable Allowance be Recorded at the Time a Sale With a Right of Return is Recognized or if no Reasonable Allowance can be Made, No Revenue Should Be Recognized

93. The extended dating given to customers at March 31, 1987, made it critical that WOW provide reasonable estimates of the returns that would result from those sales. As early as May 7, 1987, John Forsythe wrote to Baldev Madahar that: "The single greatest issue severely impacting collections is unsold inventory on retail shelves. The shipping of product in late December and January *loaded* in inventory to the retailers at the time that demand was on the down side. Numerous major accounts are withholding payment until W.O.W. either takes product back or redates invoices" (emphasis added). Forsythe Decl., Exh H.

94. On June 10, 1987, John Forsythe issued another memorandum, which identified significant product return issues at that date:

(a) Toys R Us – $686,000 in open deductions for pricing errors and alleged short shipments.

(b) Service Merchandise – $41,000 credit not on accounts receivable.

(c) Srepco Electronics – large return in March 1987 still not credited.

(d) Child World – large amount of advertising deductions taken, and returns have not been credited yet.

(e) Wal-Mart – large amount of returns not credited. (See also the section in this declaration discussing Wal-Mart, wherein Wal-Mart return credit memo's for April 1987 were, at least, $1.3 million).

95. In an August 27, 1987 inter-office memo to Baldev Madahar, John Forsythe highlighted the reasons for WOW's customers lack of payment. The memo states: "Over 50 percent of the nonpayment problems involve either returns not credited or reconciliations involving returns issues. Considering the fact that months pass before a customer return is processed through the system, I do not anticipate the resolution of these problems in the near future." Exh. 59 WOR0164746-761.

96. The returns associated with the K-Mart transaction of March 1987 amounted to $9.9 million. In October 1987, K-Mart submitted a deduction voucher covering the return of good product and stock balancing. Exh. 60.

97. An internal WOW memorandum from Phil Rosenberg to Jim Whims identifies extremely high defective rates with regard to Teddy Ruxpin and Grubby products by Toys R Us and Target. The memorandum is dated September 4, 1986 and indicates that the defective rate is for the last 30-day period. The following defective rates were indicated:

Target	Defective Rate
TRX	22%
Grubby	16%
Toys R Us	
TRX	27.9%
Grubby	14.2%

98. At March 31, 1987, WOW estimated returns based primarily upon defective returns, and provided a minimal provision for good product returns, at sales value, of approximately $1.2 million. WOW's defective return rate utilized for Teddy Ruxpin in the March 1987 analysis was 14.5%. No provision was recorded at March 1987 for any stock balancing under the K-Mart agreement or any other informal or formal stock balancing arrangements. By May 6, 1987, WOW knew that K-Mart wanted WOW to "sell off" a 100,000 pieces of Lazer Tag product. This alone represents a return sales value in excess of $3.6 million.

99. By May 1987, the market for WOW's product, especially Lazer Tag, was saturated and numerous customers had inventory overstock. WOW and Deloitte had knowledge of the following factors which should have raised concern that the return reserves were materially understated at March 31, 1987.

(a) K-Mart, one of WOW's largest customers, was informing WOW that it would not be taking delivery of at least 100,000 Lazer Tag products. This alone represents a revenue decrease in excess of $3.6 million.

(b) The return rate for Teddy Ruxpin of 14.5% of product was materially understated at March 31, 1987. Deloitte acknowledged that the fiscal 1986 return

rate should have been approximately 20%. At December 1987, WOW's return rate, as calculated by Deloitte, for Teddy Ruxpin since inception of product, was 21%. In determining the amount of reserves necessary to reduce accounts receivable, Deloitte and WOW utilized a defective rate of 14.5% which yields an expected amount of future TRX returns of 90,000 units. This equals a reserve of approximately $3.3 million. In the inventory section of its workpapers, Deloitte determined that expected returns for Teddy Ruxpin would be 122,000 units. This difference represents an understatement of the receivable reserve by approximately $1.5 million. Additionally, Deloitte's expected return rate was understated since it utilized a 11% defective rate for version D bears, versus defective rates of 22% and 20%, for versions A and B, and C, respectively.

(c) On July 15, 1987, Toys R Us in a letter to Kingsborough, "reiterate[s] the ongoing problems that we are both facing on our inventory" and identifies overstock items. Toys R Us states it had *193,000* units of Lazer Tag on hand and only sold *919* units during the past week. The letter further states "The Snoopy and Mother Goose tapes are a major problem that will not go away. The Lazer Tag accessories seem hopeless." Exh. 142.

c. Deloitte's Audit was not in compliance with GAAS

100. Deloitte's audit procedures regarding sales returns and allowances were reckless and violated GAAS. Deloitte violated the following applicable GAAS –

Deloitte failed to maintain an independent mental attitude, failed to exercise due professional care, failed to obtain sufficient competent evidential matter to support its opinion, and failed to insist that WOW present its financial statements in accordance with GAAP. Deloitte failed in the performance of its duties in the following ways, among others:

(a) While identifying the area of return reserves as a "high risk" area, Deloitte failed to treat it with appropriate thoroughness, independence and professional skepticism. Deloitte, although aware of the stock balancing provision of K-Mart's Blanket Order No. 3, made no effort to perform any procedures or record a reserve as a result of the stock balancing granted to customers. As a result of stock balancing, K-Mart would return in excess of $9 million of product in October 1987.

(b) As noted throughout this declaration, the inventory build-up of WOW, the overstock positions of customers, the acceptance by WOW of good product returns, stock balancing rights, and high defective rates on the Teddy Ruxpin product created an environment wherein Deloitte should have been conservative in auditing return reserves. Instead, Deloitte failed to insist WOW record reserves for stock balancing, and Deloitte again accepted managements unverified representations as to low defective rates.

3. Reserves for Inventory were Inadequate

a. Introduction

101. At March 31, 1987, WOW had recorded reserves for excess, obsolete, and scrap inventory and lower of cost or market reserves of $1.2 million, or approximately 2% of its total inventory value. However, Deloitte should have been aware that, as noted in the chart below, WOW's inventory had dramatically increased, sales had peaked, and, as noted throughout this declaration the market was saturated with product. This situation subsequently, resulted in WOW recording huge inventory writedowns during the next 9 months.

102. WOW's inventory showed the following inventory and sales increases (including the dated sales programs which had absorbed a significant portion of 1987's demand for existing product):

		Inventory (000's)	Quarterly (000's) sales
December 31, 1986		$ 17,689	$ 132,771
March 31, 1987		$ 56,347	$ 109,458
June 30, 1987		$ 94,453	$ 22,953
September 30, 1987	$ 128,481*	$ 49,705	
December 31, 1987	$ 82,588**	$ 37,058	

*Net of inventory reserves of $10,255,000.

**Net of inventory reserves of $50,072,000.

103. In my opinion, it was improper under GAAP for WOW to *not* record additional inventory reserves for

excess, scrap and obsolete inventory and lower of cost or market writedowns at March 31, 1987. Additionally, Deloitte's audit work on WOW's inventory reserves fell far short of GAAS. In the section that follows, I explain the reasons for my opinion.

b. Inventory Writedowns Under GAAP

(1) Inventory Standards Under GAAP

104. The authoritative literature on inventory reserves is ARB No. 43, Chapter 4. ARB No. 43 states: "A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period." It further states that the loss recorded on inventory under this principle should be at a level designated as "market" for the goods. "Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal)." GAAP also addresses losses on firm purchase commitments for goods for inventory, such as those entered into by WOW. ARB No. 43 states: "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts there of separately disclosed in the income statement. The recognition in a

current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory items."

(2) Inventory Writedowns Were Required Under GAAP Because WOW Had Significant Excess Inventory at March 31, 1987

105. Inventory levels at WOW had dramatically increased at March 31, 1987 and continued to grow through June 1987. These increases were: (1) in spite of WOW recording as revenue, thus reducing inventory, approximately $52 million in dated sales at March 31, 1987, and (2) a significant decrease in net sales during the quarter ended June 30, 1987 from the prior quarter, and a decrease from the corresponding quarter of the prior year. The following sections explain the reasons for my opinions.

(1) The Declaration of John G. Forsythe identifies the inventory and market conditions WOW was experiencing during early 1987 through June 1987. The demand for Lazer Tag, one of WOW's major products, had declined dramatically and customers were overstocked.[15]

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[15] However, by February, 1987, I learned that consumer demand for the Lazer Tag line had declined dramatically beginning immediately after Christmas. The problem persisted and deepened during the months of February, March, April and

(2) As noted throughout this declaration, WOW's major customers had overstocked inventory, especiallywith [sic] respect to Lazer Tag, and the "pipelines were stuffed." The sell through of Lazer Tag and other WOW products was poor.

(3) The condition identified in (b) above, the tremendous inventory build-up of WOW from March to June 1987, and the cash flow constraints of WOW would force WOW to lower its sale price of its inventory.

May, 1987 and, indeed, continued through the time I ultimately left the company in November, 1987. During the months of February, March, April and May, 1987, I understood that it was common knowledge among the WOW sales personnel and manufacturers' representatives with whom I was in constant communication, as well as among many of the Company's customers with whom I spoke, that demand for products in the Lazer Tag line had collapsed and that the level of sell-through at the retail level was terrible. During this time, I understood on the basis of my conversations with the WOW sales personnel and manufacturers' representatives with whom I was in communication that the "pipelines were stuffed" with Lazer Tag kits and accessories, as well as with Teddy Ruxpin books, tapes an [sic] software. I also understood on the basis of my conversations with many of the retailers that I dealt with during the months of March, April and May, 1987 that they were severely overstocked on Lazer Tag kits and accessories and that the products were not moving. This was particularly striking because I was aware that the Company was trying to promote Lazer Tag as an outdoor toy and wa [sic] hoping that it could sell substantial quantities of the product during the Spring and Summer rather than solely during the Christmas season. By May, 1987, I understood, on the basis of my conversations with customers that a substantial number of customers wanted to return excess inventory of Lazer Tag products. Forsythe decl. at ¶25.

WOW did not have the capital to support $90 million of inventory level.

c. Deloitte's Audit of Inventory Reserves was At Best Cursory

106. In my opinion, Deloitte's audit procedures of WOW's excess, obsolete, scrap and lower of cost or market reserves at March 1987 was grossly deficient and fell far short of the standards imposed by GAAS. Deloitte violated the following GAAS – Deloitte failed to exercise due professional care, work was not adequately planned and supervised, sufficient competent evidential matter was not obtained to support Deloitte's opinion, and Deloitte failed to insist that WOW's financial statements be presented in conformity with GAAP. Deloitte failed in its duties in the following ways, among others:

(a) GAAS requires that the auditor "obtain a knowledge of matters that relate to the nature of the entity's business, its organization and its operating characteristics. . . . other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios should also be considered by the auditor." (AU Section 311.07) Deloitte completely failed to evaluate the reasonableness of the valuation of WOW's ending inventory. Deloitte had or should have had knowledge of all the conditions identified in section (2) above.

(b) Deloitte's analysis of excess inventory was superficial and grossly deficient. Deloitte prepared an analysis of inventory quantities on hand,

inventory intransit, and purchase commitments, by product, at March 31, 1987, and compared that to forecasted sales for products for fiscal 1988. Deloitte performed *no* procedures to review the propriety of management's forecasted sales for fiscal 1988, except to agree the amounts to 1988 budgets. The forecasted sales amounts are the most critical component of the analysis, and again, Deloitte relies solely upon management estimates, without any independent review. Deloitte's lack of procedures regarding inventory valuation when it has extensive knowledge of WOW's inventory levels, cash flow and sales problems is reckless.

F. Failure to Disclose Significant Fourth Quarter Adjustments

1. Introduction

107. At March 31, 1987, WOW capitalized (reclassified from expense to an asset) parts inventory which had been previously expensed throughout the fiscal year. The amount of this adjustment was approximately $2.5 million. Deloitte's work papers state: "Amount represents parts inventory physically held at WOW, Gemini and MPI. Throughout the year WOW expensed its parts inventory. However, in conformity with WOW's prior year policy, per discussion w/Baldev Madahar, Cont., the value of parts on hand were reversed from COGS and capitalized in the parts inventory account."

2. Applicable GAAP

108. The authoritative literature on interim financial reporting, APB Opinion No. 28, states the following regarding significant fourth quarter adjustments:

> "When interim financial data and disclosures are not separately reported for the fourth quarter, securityholders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results for that quarter in the annual report, disposal of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, *as well as the aggregate effect of year-end adjustments which are material to the results of that quarter should be disclosed in the annual report in a note to the annual financial statements* (emphasis added)."

109. The reported earnings before taxes of WOW for the fourth quarter of 1987 were $288,000. An adjustment to record $2.5 million of earnings as a result of capitalizing previously expensed parts inventory was material to the fourth quarter financial statements and the earnings trend. Without the capitalization of parts inventory WOW would have reported a loss before taxes of approximately $2 million.

110. In my opinion, due to the material amount of the adjustment to record parts inventory on the fourth quarter earnings and the fourth quarter earnings trend, disclosure of the capitalization of parts inventory was

required as a significant fourth quarter adjustment, specified in APB Opinion No. 28.

3. Deloitte's Audit Procedures Fell Far Short of GAAS

111. Deloitte's audit procedures with respect to the capitalization of the parts inventory at March 31, 1987 were superficial at best. The "Audit Summary Memorandum" prepared as a result of Deloitte's audit of WOW for March 31, 1987, states: "In addition, the client capitalized $2700[000] of parts inventory which they had previously expensed throughout 1987." The audit workpapers lack documentation that Deloitte performed any procedures to determine the amount of parts inventory on hand at the prior fiscal quarters – December 31, September 30, and June 30, 1986. This would have been necessary to formulate an opinion as to the immateriality of the fourth quarter adjustment of capitalizing $2.5 million of parts inventory. Additionally, it is unreasonable that WOW would not have had any parts inventory at these prior dates.

112. Furthermore, Deloitte acknowledged in its management letter for fiscal year 1987 that WOW had *"[i]naccurate* monthly financial statements which required *significant* year-end adjustments" (emphasis added). Again, Deloitte assisted WOW in promulgating false and misleading financial statements to present to the public an image of a company with sound accounting systems and accurate financial reporting. Furthermore, Deloitte in its review of the debenture offering affirmatively states that "these adjustments [DH&S audit adjustments] are

significant and *unusual* in nature and will *distort* comparison if not reversed" (emphasis added). Exh. 210. See DTOO2272. Deloitte failed to disclose any fourth quarter adjustments, including the capitalization of parts inventory, and therefore it knew that the fourth quarter financial results were distorted as reported.

G. FAILURE TO DISCLOSE EFFECT ON FUTURE REVENUE AS A RESULT OF DATING PROGRAM

1. WOW's Dating Program Significantly Affected Fiscal 1988 Sales

113. As noted in my earlier discussion of the March 1987 dating program, the program provided extended payment terms to customers until December 10, 1987. In other words, customers would have nine months to sell the goods, including the 1987 Christmas season. Under the terms of many of the dating sales, WOW warehoused goods for the purchasers until they requested that the goods be delivered to their distribution centers or stores, and placed into their retail store inventory. There is no question that the dating program at March 31, 1987 had the effect of "accelerating" revenue into the fiscal year 1987 from fiscal year 1988. If WOW had maintained its normal terms of sale these sales would have been recorded, if at all, in fiscal 1988. Deloitte, as previously discussed, documents this in its workpapers and memoranda.

2. GAAP Requires Disclosure of Effect of Dating Program

APB Statement of No. 4 states:

> In general, information that might affect the conclusions formed by a reasonably informed reader of the financial statements should be disclosed. Disclosure principles carry an implied responsibility to present information so that its significance is apparent to a reasonably informed reader. A mass of detailed information, overly compressed information, and language that may be a barrier to communication are unsatisfactory. Financial statements should inform the reader of matters that may affect his interpretation of them, and may provide additional information that will facilitate his understanding and use of the statements.

114. The March 31, 1987, financial statements of WOW did not contain any disclosure of the dated receivables nor the impact the dating program would have on fiscal 1988 sales. The dating program was significant to WOW's revenue, earnings and financial trends, as noted in this declaration, and as such disclosure of the program and the effects thereof was required under GAAP. FASB Statement of Concepts No. 1 requires that information about an enterprise's performance and earnings should be useful to investors and creditors in assessing the prospects of the enterprise and "representative" (normal recurring activities) of the earning ability of the

enterprise.[16] Additionally, GAAP requires disclosure of the dating terms given on the receivables and the fact that revenue was recognized on goods *not* shipped to customers. WOW's disclosure of recognizing revenue upon shipment contained in the March 31, 1987 financial statements was false and misleading.

3. Deloitte's Failure to Comply with GAAS

115. In my opinion, Deloitte failed to comply with GAAS for the following reasons:

a) The third statement of reporting states:

"Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. The presentation of financial

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[16] FASB STATEMENT OF CONCEPTS NO. 1 STATES: Investors, creditors, and others often use reported earnings and information about the components of earnings in various ways and for various purposes in assessing their prospects for cash flows from investments in or loans to an enterprise. For example, they may use earnings information to help them (a) evaluate management's performance, (b) estimate "earning power" or other amounts they perceive as "representative" of long term earning ability of an enterprise, (c) predict future earnings, or (d) assess the risk of investing in or lending to an enterprise. They may use the information to confirm, reassure themselves about, or reject or change their own or others' earlier predictions or assessments. Measures of earnings and information about earnings disclosed by financial reporting should, to the extent possible, be useful for those and similar uses and purposes. (FASB Stmnt Concepts)

statements in conformity with GAAP includes adequate disclosure of material matters." (AU Section 431). As noted above, Deloitte failed to require any, much less adequate, disclosure of the dating program in the financial statements.

b) Deloitte failed to exercise due professional care in the performance of its audit and the preparation of the report. (AU Section 230). There is no evidence that Deloitte considered the detrimental effect the dating program would have on fiscal 1988, if revenue was recognized at March 31, 1987.

c) Deloitte failed to obtain sufficient competent evidential matter to support its opinion that the dating program would not detrimentally effect [sic] future years revenues and earnings. (AU Section 326). Deloitte failed to apply any substantive procedures to disclosing the effect of the recognition of revenue on Dated Sales.

III

OPINIONS REGARDING WOW'S DECEMBER 31, 1986 FINANCIAL STATEMENTS

A. WOW's December FOB Program

116. In December 1986, WOW instituted an "FOB Program" whereby customer's orders were recorded as sales upon WOW's product shipping from Hong Kong to WOW USA as opposed to the recording of sales upon product shipment from WOW's U.S. warehouse. WOW, under the FOB Program, agreed and was responsible for the payment of *all* transportation, freight, insurance, and

U.S. custom duty charges and for delivery to the customer's ultimate destination. Additionally, WOW retained a security interest in the merchandise until delivery to the customer. As a result of the FOB Program, WOW recorded sales of approximately $20 million at December 31, 1986.

1. Terms of the December FOB Transactions

117. The terms of the December FOB Program "sales" required that special terms of sale be placed on each order prior to WOW releasing the order. The specific language required for each purchase order was: "Sale in transit to United States: Seller agrees on behalf of Buyer to obtain and be responsible for payment of all transportation, freight, insurance (marine, war risks and inland) and U.S. Customs duty charges for delivery to ultimate destination specified on the purchase order, (including arranging for independent quality check of the merchandise) with Seller to retain security interest in the merchandise until delivery."

2. Under GAAP, Revenue Should not Have Been Recognized on the December 1986 FOB Transactions

118. As noted previously, it was WOW's standard policy, in practice, to allow customers to return non-defective merchandise for credit after shipment. As a result of this practice *all* of WOW's sales had to meet the specified criteria set forth in FASB No. 48 before revenue could be recognized on a transaction. Specifically, WOW's

December 1986 FOB Program did not meet the condition that: "The buyer's obligation to the seller could not be changed in the event of theft or physical destruction or damage to the product." WOW had ongoing obligations to pay and provide insurance on the product, to perform quality control functions, and to bring about transportation of the product to the ultimate customer destination. Additionally, as noted in APB Statement No. 4, GAAP required that the earnings process be complete prior to recognizing revenue on a transaction. The obligations of WOW with respect to the December 1986 FOB transactions constituted significant performance that must be complete prior to revenue recognition. Furthermore, Mr. Barrington testified that the customer did *not* bear the risk of loss with respect to WOW's December FOB sales, as required by GAAP before revenue recognition could occur.[17]

119. As noted in the Declaration of John Forsythe, "it was common knowledge within the Company that the FOB program was a device to generate sales that WOW would not have gotten in that quarter, and that the FOB

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[17] Q: Did the customer bear the risk of loss or damage to the merchandise under the 12/31/86 FOB sales?
Q: While the goods were in transit?
A: I believe that while the goods were in transit that risk of physical loss had not transferred –
Q: What –
A: – to the buyer.
Q: Sorry.
A: The risk of [physical] loss had not transferred to the buyer.
Q: And also physical damage, correct?
A: Yeah.
(Barrington dep. p 142-3.)

transactions had been entered into in order to pump up WOW's reported sales numbers for the third quarter of fiscal 1987." By accelerating the recording of a sale by approximately 30 days (normal transit time of goods to the U.S., customs clearance, quality clearance and shipment to the customer), WOW stole from fourth quarter fiscal 1987 sales to inflate December 31, 1986 sales' numbers.

3. Deloitte's Role in the December 1986 FOB Program

120. Deloitte was an active participant in the structuring and review of the December 1986 FOB Program instituted by WOW. A November 25, 1986 interoffice memorandum from Eric Roberts and Ronald Barrington documents a meeting held on November 24, 1986, with Baldev Madahar, WOW's controller, to discuss the FOB Program. The memorandum documents that Deloitte was aware of the following: (a) "In order to *enhance* sales and give retailers a priority position in these products, WOW has instituted the FOB Program which works as follows: Buyers wishing initial shipments of these products will issue a purchase order stating that the goods may be shipped FOB Hong Kong for talking toy products. WOW will arrange and pay for the shipment, insurance, customs, warehousing and inspection of these goods until they reach the Buyer's designated *destination*" (emphasis added).

121. It appears that the purpose of the meeting was to determine whether or not Deloitte would pass upon the recognition of revenue at December 1986 on products

sold under the FOB Program. While Deloitte did not perform audit procedures with respect to the December 31, 1986 financial statements of WOW, Deloitte did determine that it was proper to recognize revenue upon shipment from Hong Kong for products sold under the FOB Program. Clearly without Deloitte's approval of the December FOB Program and the recognition of revenue thereon, WOW would not have been able to report the sales under the December 1986 FOB Program at December 31, 1986.

122. Additionally, with respect to the December FOB Program Deloitte states the following: "At the end of the 3Q87, WOW recorded sales of approximately $18 million under its 12/31/86 FOB Program. Because of QA and inspection problems, most of the FOB goods were not received by retailers until mid-late February per discussions with J. Forsythe, credit manager. As a result, through the end of April 1987, WOW still had approximately $8 million unpaid FOB invoices." Exh. 61. This subsequent payment information should have alerted Deloitte to the fact that the customers had *not* accepted ownership upon shipment of the product from the Orient. The customers clearly extended their payment dates based upon *actual* receipt of the goods at their facilities. If the merchandise had been exchanged at December 31, 1986, the actual receipt of merchandise by the customers should have had *no* bearing upon payment terms.

B. Consignment Sales at December 31, 1986

123. At December 31, 1986, WOW had improperly recognized revenue on consignment sale transactions for,

at least, $2.5 million. A consignment sale is a transaction wherein the customer does not have to pay for products purchased until the customer resells the product. Additionally, the customer has full right of return with respect to the product unless resale occurs.

124. GAAP *prohibits* revenue recognition on goods consigned to customers. The issue with respect to the impropriety of revenue recognition on the consignment sales at December 1986 is clear. As documented in a Deloitte interoffice memorandum prepared by Ronald Barrington it states: "On March 3, 1987, Richard Stein, WOW's CFO, informed Eric Roberts that WOW International and WOW-U.S. had improperly recorded revenue because certain sales, in effect, been made on a consignment basis." Exh. 62. In a memorandum dated March 10, 1987, Jeff Wolf, WOW's internal auditor, stated: "I have reviewed certain transactions recorded as sales to BNS Trade S.A. over the period June, 1986 through December 1986. . . . While some of the product appears to have been ordered as stock to support a distributor role for the U.S. military and Europe and the Middle East, at least 1,600k of the related product was, and to a large extent still is, stored at WOW International's expense at Belgium and Hong Kong warehouses. WOW International has shared responsibility for locating subsequent purchasers of the product, and BNS has not been expected to pay for this product until it has collected on the on such subsequent resales." The memorandum further states: "The fact that this product has been shipped and invoiced from both Hong Kong and the U.S. is a *compelling* indication that these shipments were *coordinated* by, or *made* at the *direction* of, *WOW management* in Freemont. . . . It seems

highly unlikely that this individual or others acted unilaterally, or without the knowledge of other corporate level personnel." (emphasis added). Exh. 63.

125. Additionally, when Deloitte was performing its confirmation procedures with respect to February 28, 1987 receivables, it uncovered another consignment sales transaction with Wilson Printing & Premium, Inc. The confirmation was for an invoice in the amount of $525,240. In response to the confirmation, the customer stated: "See our attached purchase order. Merchandise is consigned to Wilsons on condition that all not sold may be returned for full credit as of April 30, 1987." Exh. 5.

C. WOW's Improper Sales Cut Off at December 31, 1986

126. A Deloitte memorandum regarding its review of the quarter ended December 31, 1986 notes that: "There was some $2 million of product recorded as 3rd quarter sales which were actually shipped on the first day of the first quarter." Exh. 64. As noted previously, GAAP requires delivery to the customer prior to revenue recognition. Deloitte failed to require WOW to adjust its financial statements for the improper recognition of these sales.

IV

OPINIONS REGARDING WOW'S MARCH 31, 1986 FINANCIAL STATEMENTS

A. Introduction

127. In my opinion, the March 31, 1986 financial statements of WOW were materially misleading for

failure to accrue adequate reserves for returned goods and inadequately estimating returns and allowances to arrive at a net sales figure. As noted previously, GAAP requires that adequate estimates of returns be recorded when the corresponding sales are recognized. The sales return percentage of WOW's Teddy Ruxpin product was significant throughout fiscal 1986 to fiscal 1988.

128. In the performance of its review procedures on the June 30, 1986 financial statements of WOW Deloitte determined that WOW booked approximately $1,844,000 of good product returns, and, through discussions with Baldev Madahar and Mark Bradlee, estimated that approximately 50%-60% of the returns were for sales recorded in fiscal year ended March 31, 1986. Deloitte estimated the pre-tax effect of said returns was to reduce reported earnings by approximately $761,000. Subsequently, in performing its audit on the March 31, 1987 financial statements of WOW, Deloitte noted that the return rate for fiscal year ended March 31, 1986 should have been approximately 20%. The additional reduction to March 31, 1986 reported earnings, if a return rate of 20% would have been utilized, was approximately $2.0 million. Therefore, WOW, at a minimum, overstated its reported earnings before taxes at March 31, 1986 by approximately $2.8 million, or a 22% overstatement.

B. Deloitte's Audit Procedures Failed to Comply with GAAS

129. Deloitte, at March 31, 1986, again placed undue reliance upon management representations without obtaining sufficient competent evidential matter. Deloitte

in its analysis of returns, at March 31, 1986, determined that WOW had experienced an approximate return percentage of 19.5% on the Nylon model bears. However, Deloitte, based solely upon management representations that the new metal model bears were not experiencing high return rates, determined that a return rate of less than 1% was reasonable. However, as noted in the June 16, 1986 prospectus: "The Company commenced shipments in late December 1985 of a modified version of Teddy Ruxpin intended to correct the problem [Company attributed high rate of returns to failures in built-in cassette player.]" Exh. 65.

130. Since the new model bears had not been shipped from WOW until late December, considering the amount of time it would take for customers to receive the product, stock it into retail store inventory, sell-through to the retail customer, the retail customer return the defective product to the store and the customer return the product to WOW, the defective return rate on the new version would be extremely low. Not enough time would have elapsed to allow the return sequence to occur. Additionally, the quarter from January to March generally has low retail toy sales and therefore a significant amount of the new model toys would still be in store inventories.

131. Deloitte failed to obtain sufficient competent evidential matter to support its work that the return rate on the bears had been reduced from approximately 20% to less than 1%, failed to exercise an independence in mental attitude and failed to exercise informed professional skepticism. Deloitte in its planning memorandum had identified the reserves for returns as a "high risk"

audit area, however, failed to properly conduct its audit procedures in light of such determination.

V

INTERNAL ACCOUNTING CONTROL

A. Introduction

132. As defined in the authoritative literature,

> "Internal control, in the broad sense, includes . . . control which may be characterized as either accounting or administrative as follows:
>
> a. Accounting controls comprise the plan or organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.
>
> b. Administrative controls comprise the plan of organization and all methods and procedures that ate [sic] concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls."

133. Deloitte prepared management letters for both March 31, 1986 and 1987 which identified numerous internal control weaknesses. The letters began with a summary regarding WOW as follows:

> "In its two years of existence, Worlds of Wonder, Inc. (the Company) has experienced a phenomenal rate of growth. *This growth, however, has contributed, in part, to a company-wide environment in which the operating disciplines normally associated with a large organization do not exist.* Examples of this lack of discipline include policies and procedures, when established, not being consistently followed; critical deadlines being missed; meetings being cancelled or not starting on time, and unplanned and sometimes excessive staff overtime.
>
> Much of the following letter relates to the accounting and finance function. This function, however, should *not* be singled out within the Company. Rather this letter reflects the fact that (a) we spent the predominance of our time working with accounting and finance, and (b) our expertise is primarily in those areas.
>
> *Accounting and Finance personnel, financial controls, and systems as of the date of our audit report were hardly sufficient to support WOW's existing operations and probably will not be sufficient to support growth. This situation greatly reduces the possibility that the Company will have reliable and timely information for either planning and controlling operations or for reporting financial reports internally or externally.* In order for the Company to correct his [sic] situation, the following areas need to be given immediate executive level

attention as well as the necessary resources" (emphasis added).

B. WOW's Weaknesses in Internal Control at March 31, 1986

1. Deloitte's 1986 Management Letter

134. As clearly noted in Deloitte's management letter to WOW dated May 2, 1986, as a result of the September 28, 1985 audit, "Existing controls and systems are insufficient to support the high rate of growth WOW is projecting. Controls need to be improved to encompass the risks inherent in the large dollar amounts of cash, receivables, and inventory accompanying high growth, as well as to ensure good and consistent internal financial reporting. The current data processing system is inadequate for WOW's continuing needs as it is inflexible and not interactive." The letter further identified weaknesses in accounts payable, accrued liabilities, return reserves, and account reconciliations.

135. On July 10, 1986, Deloitte issued a management letter as a result of its audit of WOW's March 31, 1986 financial statements. This management letter addresses Deloitte's concerns regarding interim financial results stating: "as a result, interim financial results may not always be relied upon." The letter further identified control weaknesses regarding journal entries, product return procedures, point of purchase displays, and legal agreements.

136. In Deloitte's workpapers supporting the management letter, the files indicate that Deloitte prepared 34

"constructive service fact sheets" (Deloitte's internal form for accumulating information to be included in management letters). The forms included the following significant comments:

(a) Accounts receivable detail aging is not being reconciled on a periodic basis.

(b) Regarding journal entries – numerous journal entries lacked supporting documentation, and a series of approximately 35 journal entries was missing.

(c) Estimates of expected product returns were too low and required a material adjustment at fiscal year end.

C. **WOW's Weaknesses in Internal Control at March 31, 1987**

137. On July 31, 1987, Deloitte issued its management letter to WOW as a result of its 1987 audit. The letter acknowledged: "Accounting and Finance personnel, financial controls, and systems as of the date of our audit report were *hardly sufficient* to support WOW's existing operations and probably will not be sufficient to support growth. This situation greatly reduces the possibility that the Company will have *reliable* and *timely* information for either planning and controlling operations or for *reporting financial* results internally or *externally*" (emphasis added). Furthermore, the letter stated with

respect to the accounting and finance function at WOW: *"In summary, the department appeared to lack the discipline, direction, and supervision necessary to provide management with accurate and timely financial data. . . . The above resulted in: Inaccurate monthly financial statements which required significant year-end adjustments"* (emphasis added).

138. Additionally, on September 1, 1987, Deloitte issued to WOW management a letter detailing other items for management's attention. The letter encompassed *19* pages of additional weaknesses in internal controls at WOW. These weaknesses, included, but are not limited to:

a) Lack of adequate documentation supporting March 1987 returns, and reiterates that in fiscal 1987 WOW began receiving good product returns.

b) Interim reconciliations of cash, accounts receivable, inventory, intercompany balances, point-of-purchase displays were not performed on a timely basis and WOW recorded *significant* year-end adjustments as a result of reconciling these accounts.

c) WOW experienced problems with refused shipments, collection delays and consignment sales in accounts receivable.

d) Numerous EDP weaknesses were identified.

139. Previously, in January 1987, Deloitte submitted to WOW a comparison of a "Typical $300 million Public Company" versus WOW. The document highlights the following weaknesses known to Deloitte:

a) "Financial statement problems often do not have priority. Thus, if prioritization is incorrect or time constraints are dramatic, potentially material problems may not be addressed."

b) "Other than CFO, no experienced external reporting function exists. DH&S responsible for preparation of financial report which will change substantially from prior year. In prior two audits fairly long management reports were prepared and maybe required again this year."

D. Deloitte's failure to comply with GAAS

140. GAAS requires an auditor to "communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that come to his attention during an examination of financial statements made in accordance with GAAS." As defined in SAS No. 30, a material weakness is:

> A weakness in internal accounting control is a condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective – that is, errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A weakness is material if the condition results in more than a relatively low risk of such errors or irregularities in amounts that would be material in relation to financial statements.

141. In its management letters, as a result of both the audits for fiscal 1986 and 1987, Deloitte acknowledges the very essence and substance of material weaknesses in internal accounting controls. For March 31, 1986, Deloitte states: "Interim financial statements may *not* always be *relied* upon" (emphasis added). For March 31, 1987, Deloitte acknowledges: "[i]n summary, the department appeared to *lack* the discipline, direction, and supervision necessary to provide management with *accurate* and *timely* financial data. . . . The above resulted in: *[i]naccurate* monthly financial statements which required *significant* year-end adjustments" (emphasis added). These types of weaknesses are material weaknesses – they result "in more than a *relatively low* risk of such errors or irregularities in amounts that would be material in relation to financial statements," i.e. make the financial statements unreliable. Again, Deloitte lacks any independence and fails to affirmatively state that WOW had material weaknesses in internal accounting control. Deloitte failed to disclose WOW's weaknesses as material to avoid putting the banks, underwriters and the public on notice of WOW's lack of controls, lack of adequate personnel, and lack of capability to prepare "accurate" and "timely" financial reporting.

142. In my opinion, the above identified weaknesses comprise material weaknesses in the internal accounting controls of WOW. Reasonable auditors based upon these facts and circumstances cannot disagree. Deloitte's failure to identify said weaknesses as material weaknesses was a violation of GAAS.

VI

WOW WAS NOT A GOING CONCERN AT MARCH 31, 1987

A. Introduction

143. GAAS required that the auditor issue a qualified opinion (an "except for" opinion) on an entity's financial statements when information came to the auditor's attention that raised questions as to the entity's ability to continue in business. The applicable GAAS at the time Deloitte performed its audits of WOW was SAS No. 34, "The Auditor's Consideration When a Question Arises About an Entity's Continued Existence." SAS No. 34 requires:

> "In an examination of financial statements in accordance with generally accepted auditing standards, the auditor does not search for evidential matter relating to the entity's continued existence because, in the absence of information to the contrary, an entity's continuation is usually assumed in financial accounting. Nevertheless, the auditor remains aware that auditing procedures applied primarily for other purposes may bring to his attention information contrary to that assumption. In forming an opinion on the financial statements, the auditor considers any such contrary information, together with any factors tending to mitigate that information and any management plans for dealing with the underlying conditions."

B. Deloitte's Audit Opinion of WOW at March 31, 1987 Failed to Comply With GAAS

144. In my opinion, it was improper under GAAS for Deloitte to issue an unqualified opinion of WOW's March 31, 1987 financial statements. Moreover, Deloitte's audit work in supporting its opinion fell far short of the level necessary to satisfy GAAS. In the sections that follow, I explain the reasons for my opinion.

1. Inventory Overstock and Sales Plummet

145. At June 1987, WOW's inventory levels had dramatically increased to in excess of $90 million. Additionally, WOW had outstanding purchase commitments of goods that would be arriving within 60 days. See the discussion in the price protection, sales returns, and inventory reserve sections of this declaration. Deloitte was aware, or should have been aware, of all of these facts.

146. Even with the improper recording of sales in the fourth quarter of fiscal 1987 to inflate its earnings, WOW still had a tremendous inventory build-up. The impact of WOW's sales practices in the fourth quarter of 1987 was to significantly reduce, at least, the sales in WOW's first two quarters of fiscal 1988. Deloitte had knowledge that product was being held for major customers for future deliveries in calendar 1987, under the dating program at March 31, 1987. It must be remembered that the $52 million in *dated* sales had already reduced the inventory amounts reported at March 31, 1987, by approximately *$30* million. WOW's sales had

dried up. WOW reported net revenue of only *$1.3* million for April. In May, WOW's net sales were only *$6.0* million. See the declaration of John G. Forsythe.

147. All the inventory and sales trends, as noted previously, were known to Deloitte. These red flags were indicators of significant negative financial trends occuring at WOW. As Deloitte notes in its first quarter fiscal 1988 review: "WOW-USA sales decreased [approximately] 15% from 1Q87, due to large sales push in the final Q of 1987, which *precluded* 1Q88 sales. Additionally, TRX was less than a year old last year, as opposed to having seen 2 Christmas seasons by this Q. Additionally, much of the World of TRX and the Pleasant Dreams line have been discontinued" (emphasis added).

2. Cash Burn

148. The inventory build-up created a tremendous cash requirement that resulted in WOW, at June 30, 1987, having virtually *no* cash after raising $80 million *less* than one month earlier. As shown in WOW's financial statements for the quarter ended June 30, 1987, WOW's cash used by operations *exceeded $47* million. At June 30, 1987, WOW had only $5 million available in its unused bank line of credit.

149. Additionally, as a result of its dating program, WOW had $52 million in accounts receivable from March 1987 "sales" not due until December 10, 1987. Furthermore, WOW's barter transactions generated no cash flow for WOW.

3. Returns, Allowances and Price Protection

150. Due to slow sales, resulting from WOW's recording as sales in March 1987 as much in future deliveries as possible, and a tremendous build-up of inventory, WOW was faced with giving additional discounts to move its product. As a result, WOW offered a "breadth of line" discount of 14% to "induce sales," in the first quarter of fiscal 1988.

151. Mr. May, in his declaration, acknowledges that an auditor must consider an entity's ability to continue in existence for a 12 month period. WOW filed for bankruptcy on December 21, 1987, *less* than 9 months from WOW's March 31, 1987 financial statements, upon which Deloitte issued an unqualified opinion dated May 14, 1987. The factors leading to the filing of WOW's bankruptcy existed during May and June 1987 as noted throughout this declaration. Contrary to Mr. May's declaration, it is *irrelevant* what WOW's sales were during the fiscal year ended March 31, 1987 (a year in which WOW improperly inflated its sales by, at least $41 million). Additionally, the fast paced growth of WOW during 1986 and 1987 contributed to the conditions of the bankruptcy filing, which included, but was not limited to, material weaknesses in internal control, tremendous inventory build-ups, lack of cash flow, and a management orientation to meet publicly disclosed earnings forecasts in order to raise additional capital.

152. Deloitte's going concern analysis, which comprises, a single workpaper, performed as of March 31, 1987, focuses solely on WOW's operating plan calling for the Company to obtain $200 million in outside financing.

William McKee, the Deloitte auditor who prepared the workpaper, concluded that the $200 million will be achieved by receiving $100 million from the debenture offering and $120 million from a renewal of WOW's bank credit facility. When WOW's debenture offering was reduced to $80 million, Deloitte's auditor Ronald Barrington concluded that the $200 million would still be obtained since WOW would receive $80 million from the offering and $120 million from the credit line. This simplistic calculation failed to address the serious conditions of WOW's financial viability which existed during March through May 1987, and which raised serious doubts about the Company's continued existence. These conditions have been identified throughout this declaration. Additionally, WOW even if it did receive a $120 million credit line, could *not* utilize the full amount of $120 million, without having eligible accounts receivable. The line of credit was *limited* to 75% of "eligible" accounts receivable, which would limit WOW's borrowing ability during fiscal 1988. In fact, at June 3, 1987, 75% of the Company's "eligible" accounts receivable amounted to approximately $80 million.

153. Deloitte's simplistic analysis showed a complete disregard for professional due care. Deloitte did *not* question the attainability of WOW's operating plan; did *not* consider the 75% "eligible" accounts receivable limitation of bank borrowings; did *not* consider the excessive inventory levels at WOW; did *not* consider the cash flow impact of the dating and bartering transactions; did *not* consider the state of the market for WOW's products, especially Lazer Tag; and did *not* consider the poor sales of WOW during April and May 1987.

154. In conclusion, the above information which Deloitte had knowledge of represented significant "contrary" information which directly bore upon WOW's ability to continue as a going concern. How was WOW going to meet future obligations and remain solvent, when even after raising $80 million the Company had virtually no available credit on its bank line of credit? This information was readily obtainable by Deloitte, and should have been considered by Deloitte prior to the June 1987 Debenture Offering. There is no documentation that Deloitte considered these factors in concluding that a going concern qualification was not required at March 31, 1987.

VII

INDEPENDENCE

A. Introduction

155. GAAS requires that: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." Furthermore, "To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners." Interrelated with the Standard of Independence is the concept of "professional skepticism." Statement on Auditing Standards No. 16 requires that: "The auditors should plan and perform his examination with an attitude of professional skepticism, recognizing that the application of his auditing procedures may produce evidential matter indicating the possibility of errors or irregularities. The scope of the auditors examination would be effected by his consideration of internal

accounting control, by the results of a substantive test, and by circumstances that raise questions concerning the integrity of management."

156. Deloitte, as documented previously in this declaration, knew that "The Company's ability to meet publicly stated revenue and earnings projections appears unlikely. Management appears willing to undertake unusual and potential improper methods to maximize sales." Deloitte was on notice prior to commencing their audit procedures with respect to the March 31, 1987 financial statements of WOW that management lacked the basic integrity necessary to place reliance upon management representations. With this increased risk of intentional distortion of the financial statements by management, Deloitte should have questioned whether accounting principles that are otherwise generally accepted, were being used in inappropriate circumstances by WOW to create a distortion of earnings. As opposed to questioning transactions in which revenue recognition was unusual and inappropriate, Deloitte participated in the structuring of those transactions, i.e., K-Mart, Barter Transactions and FOB Program.

157. In my opinion, Deloitte did not exercise an independence in mental attitude, nor the appropriate professional skepticism in the performance of its audits for the March 31, 1987 and 1986 financial statements of WOW. The following section sets forth the additional facts upon which I base this opinion. Additionally, throughout the declaration there are instances noted in which Deloitte failed to properly exercise the appropriate independence in mental attitude and professional skepticism required of an auditor under GAAS.

a. On November 5, 1986 in a letter written from the engagement partner, Eric Roberts to Donald Kingsborough, Mr. Roberts states the following: "We were, therefore, happy to provide substantial fee discounts because they represented our 'investment' in WOW. However, these arrangements allowed us to be 'made whole' when you went public." Furthermore, Roberts acknowledges Deloitte's improper billing of its fees in order to benefit the earnings of WOW. The letter states: "The $141,400 of charges relating to the IPO includes not only 'normal' IPO work, but also work related to (a) our special report (as requested by the underwriters) on the design of your EDP systems and the related internal controls, and (b) services related to your aborted private placement, charges for these two items approximated $28,000. ***We agreed to bill these services as part of the IPO because IPO fees are deducted from capital raised (capital stock) and are not, therefore, expensed on your financial statements***" (emphasis added).

b. On October 21, 1986, Deloitte in an inter-office memorandum from Eric Roberts identifies significant conflicts between Mr. Stein, CFO of WOW, and Angelo Pezzani and Donald Kingsborough. The memorandum states that Stein had the opinion that Deloitte should be fired and that Deloitte was incompetent. The memorandum indicates that Deloitte was very concerned with losing WOW as a client during this time period.

c. Additionally, in the November 5, 1986 letter to Kingsborough, Roberts highlights the importance of WOW as a client to Deloitte: "You are one of our most prized clients and it is very important that you and your

people remain happy with DH&S and the services we render."

158. In conclusion, as noted above an throughout this declaration Deloitte failed to maintain an independent mental attitude, with appropriate professional skepticism.

159. Throughout the performance of its March 31, 1986 and 1987 audits, WOW continually placed undue reliance on management representations when the true substance of transactions – K-Mart, Barter Transactions, Wal-Mart, going – concern, sales returns and allowances, dating program, FOB program, among others, indicated a different accounting treatment then that proposed by WOW. Deloitte placed reliance on management it knew was "willing to undertake unusual and potentially improper methods to maximize sales." Deloitte even compromised its independence by improperly billing its own fees to boost WOW's earnings. Deloitte documents in its own correspondence with WOW that it is making an "investment" in WOW and was primarily concerned with WOW remaining happy with Deloitte.

VIII

OTHER

A. June 30, 1986 Financial Statements Of WOW Were False And Misleading

160. In my opinion, based upon the declaration of John Forsythe, the June 30, 1986 financial statements of WOW were false and misleading for improperly recognizing revenue on consigned or "guaranteed" sales. The

declaration of Mr. Forsythe establishes that WOW recognized "guaranteed sales" as revenue in an amount of approximately $2.7 million at June 30, 1986. Additionally, as previously noted, WOW improperly recognized consigned shipments to BNS as revenue at June 30, 1986, in an amount of approximately $1.0 million. The effect of this improper revenue recognition was to *understate* the loss before taxes by approximately $1.4 million, or approximately 42%.

161. Furthermore, in the First Quarter Report to Shareholders, Mr. Kingsborough states: "Another factor affecting our earnings in the first quarter was the seasonal nature of the toy business. Rather than fighting that seasonality, WOW takes advantage of it. A majority of retail toy sales occur in the four months prior to Christmas. There are companies that try to increase sales in the first half of the year by shipping product at that time and receiving payment at the end of the Christmas season. We firmly believe our strategy of matching product shipments to consumer buying patterns represents a more efficient use of our capital." This was a misleading statement, because as noted in Mr. Forsythe's declaration, WOW had recognized a significant amount of revenue on a dated sale to Toys R Us in an amount of $3.7 million during the quarter ended June 30, 1986. Toys R Us claimed Mr. Kingsborough had agreed to the December 10, 1986 dated terms. (Forsythe Decl. at 12)

B. Deloitte Violated Its Responsibility With Respect To Subsequent Events Up To The Effective Date Of The June 4, 1987 Prospectus

162. An auditor has a responsibility under GAAS to "extend his procedures with respect to subsequent events from the date of his audit report up to the effective date or as close thereto as is reasonable and practicable in the circumstances" (AU 711.10). As a result of these procedures Deloitte was aware of the following facts:

(a) Consolidated net sales for the period April 1, 1987 to May 28, 1987 were *less* than *$7.0* million.

(b) Short-term bank debt had increased to in excess of $82 million at May 28, 1987, while accounts receivable had decreased from March 31, 1987 to May 28, 1987 by approximately $33 million.

(c) "Because of WOW's *tremendous* sales push in March when [approximately] $50 million was sold under special FOB and extended payment terms, retailer probably accelerated potential April sales to take advantage of FOB Program extended terms. Finally lower than budgeted Lazer Tag sales occured in April." (emphasis added). Exh. 26. See DTOO2279.

(d) Accounts payable had decreased by only approximately $4.5 million for the period April 1, 1987 through April 25, 1987. Inventory increased in excess of $13 million.

(e) Additionally, Deloitte was aware of *all* of the facts previously discussed in this declaration.

163. In my opinion, clearly by June 4, 1987, Deloitte had to be aware of the significant and critical financial hemmoraging occuring at WOW. Deloitte should have required revision to WOW's financial statements at March 31, 1987, based upon its additional procedures through June 4, 1987. Pending revision of the financial statements, Deloitte should have modified its report and considered withholding its consent to the use of its report on the audited financial statements in the registration statement. See AU Section 711.

XIV

CONCLUSION

164. In conclusion, the issues raised by plaintiffs regarding the false and misleading financial statements issued by WOW and Deloitte's audit opinions on those financial statements are not an attempt to "second guess" judgements made by Deloitte. The performance of an audit engagement by a professional requires the use of due care, informed judgement and professional skepticism. The selection of audit procedures best suited to each engagement requires the exercise of informed professional judgement and skill. The independent public accountant cannot merely perform audit procedures by rote. The auditor must perform his examination with an awareness that errors or irregularities can occur, which Deloitte failed to do.

165. The accounting and auditing issues involved in this litigation failed to meet the standards of mere common sense and business judgement, much less the standards applicable to an independent public accountant –

GAAS. Deloitte failed to show an understanding of the general business purpose of transactions, an independence in mental attitude and the professional approach good auditing requires. To put it in perspective, auditing requires a knowledge of the business involved, inquisitiveness, a healthy dose of skepticism, due care, and a willingness to take tough stands – in other words, thoughtful, dedicated professionalism that is responsive to the public's interest.

I declare under penalty of perjury that the foregoing is true and correct, and that this declaration was executed at Los Angeles, California, on October 26, 1992.

/s/ Albert Rossi, Jr.
Albert Rossi, Jr.

DAVID B. GOLD,
A PROFESSIONAL LAW CORPORATION
Alan R. Plutzik, Esq.
Gregory C. Moore, Esq.
Steven M. Sherman, Esq.
595 Market Street
Suite 2300
San Francisco, CA 94105

Co-Lead Counsel for Plaintiffs

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Master File No. C-87-5491 SC Class Action
This Document Relates To: ALL ACTIONS.	**EXHIBIT A TO THE DECLARATION OF ALBERT ROSSI, JR.** Date: December 11, 1992 Time: 10:00 a.m. Place: Courtroom of the Hon. Samuel Conti (Filed Nov. 10, 1992)

EXHIBIT A

ALBERT ROSSI, JR. C.P.A.

RESUME AND QUALIFICATIONS

I, Albert Rossi, Jr. am managing partner of Rossi and Company a C.P.A. firm located in Los Angeles, California. I have had my own firm since December 1, 1984.

Since December 1983, I have been active in performing litigation support services relating to accounting and auditing matters. My experience includes the following:

- Expert witness in the *FPI/Agretech Securities Litigation* in the United States District Court for the District of Hawaii. Retained by Lieff, Cabraser & Heimann, plaintiffs' class counsel, against Arthur Young and Company. Testified in August 1990 trial regarding professional negligence of Arthur Young & Company in the performance of its examination of financial statements of various entities.

- Expert witness in *Class Plaintiffs vs. Technical Equities Corporation, et al.*, in the United States District Court for the Northern District of California. Retained by David B. Gold, APC and Lieff, Cabraser and Heimann to serve as accounting expert in securities litigation involving financial statement compliance with generally accepted accounting principles (GAAP) and violations of generally accepted auditing standards (GAAS) by Company and KMG Main Hurdman.

- Expert witness in *Creeks USA Corp. v. RGA* in the United States District Court for the Central District of California. Retained by Epstein, Becker, Mulkeen & Green, counsel for Creeks. Testified in August 1990 trial regarding gross revenue derived form the sale of products alleged to have been copied in violation of copyright law.

- Retained by Defense Counsel as accounting consultant, including Parker, Milliken, Clark, O'Hara & Samuelian; Shapiro, Posell & Close; Latham & Watkins; Gibson, Dunn & Crutcher, in *CMA v. Glaser, et al.*, filed in the Superior Court of the State of California for the county of Los Angeles. Case involves numerous accounting and auditing allegations by plaintiff against defendants including Platt Music Corporation.

- Expert witness in *Class Plaintiffs vs. Consolidated Capital Equities Corporation,* Laventhol and Horwath, et al. in the United States District Court for the Northern District of California. Retained by David B. Gold, APC. Litigation involving failure of Laventhol and Horwath to comply with GAAS and failure of financial statements to conform to GAAP, primarily with respect to loan loss reserves.

- Retained as expert witness in *Sachs vs. Ernst & Whinney,* by Mazursky, Schwartz & Angelo. Litigation involves issues of lack of compliance with GAAS by Ernst & Whinney.

- Retained as expert witness in *Class Plaintiffs vs. DeLaurentiis Entertainment Group, Inc., Ernst & Whinney, et al.,* by Greenfield & Chimicles, Milberg Weiss Bershad Specthrie & Lerach, and Barrack, Rodos & Bacine. Litigation involves issues regarding financial statement conformity with GAAP and lack of compliance with GAAS by Ernst & Whinney.

- Retained by Wilmer, Cutler and Pickering, special counsel, for the Cannon Group, Inc. to provide accounting and auditing consultation in response to a Securities and Exchange Commission inquiry concerning the company's financial reporting, disclosures and systems of internal accounting controls.

- *Contemporary Services Corporation vs. Universal, et al.* Retained by Baker and McKenzie as an accounting expert. Case involved alleged violations of Unfair Practices Act regarding rendering services at less than their cost.

- *Class Plaintiffs vs. Micro Pro Corporation, et al.* Retained by Milberg, Weiss, Bershad, Specthrie and Lerach as accounting expert in securities litigation involving financial statement compliance with GAAP.

- *Stephen Palmer, et al. vs. James A. Latham, Touche Ross and Company, et al.* Retained by Munger and Myers as accounting consultant.

- *Quail Gardens Associates, Limited vs. Degen Development Corporation, et al.* Retained by Donald Tremblay, Esq. as accounting expert in litigation involving commingling of funds.

- Retained as accounting consultant in the following securities litigation cases, among others:

  ATV Corporation; Wickes Companies; Nucorp Energy, Inc.; Cousins Home Furnishings; Castle Entertainment, Inc.; Kaypro Corporation; Odetics, Inc.; Xebec Corporation; Tandon Corporation; Seafirst National Bank; Victor Technologies, Inc.; Baldwin-United Corporation; Pace Corporation; Care Enterprises; Heritage Entertainment, Inc.; and Seagate Technology, Inc.

In addition to performing litigation support services, I am still actively involved in providing accounting, audit and consulting services to the firm's clients.

Prior to forming my own firm, I was a partner in the firm of Block, Good, and Gagerman (BG&G) a large local firm of certified public accountants. BG&G had seven partners and approximately forty employees. I was in charge of the firm's accounting and auditing department. I joined BG&G in June 1982 as a manager and was promoted to partner as of February 1, 1984.

Before joining BG&G, I had my own practice which I merged into BG&G. Immediately prior to this, I was an audit manager with Brout and Company, a national firm of certified public accountants. While with Brout and

Company I developed and administered Continuing Education Programs for the Los Angeles office, functioned as Personnel Director for the professional staff, and was coordinator for the Los Angeles office's peer review. In addition, I served as audit manager for a number of public and privately-held engagements.

I received my Bachelor of Science degree in Business Administration-Accounting from California State University, Long Beach, in 1976. I joined the large local firm of Alder, Green and Hasson (AG&H) in Los Angeles upon graduation. At AG&H I received a solid background in all areas of public accounting with a major emphasis is auditing, including SEC engagements. I was a supervising senior with the firm when I left.

During my career as a certified public accountant, I have had primary client responsibility for numerous audit and non-audit/publicly-held and privately-held clients. My experience, in addition to the auditing services, has included: review of credit facilities and banking structure; cash flow forecasting and analysis; financial forecasting and analysis; accounting systems review, development and implementation; management information systems reviews; corporate organization reviews; corporate and individual tax planning and compliance; and acquisition reviews. My industry experience consists of manufacturing – light and heavy; wholesale distributors; service industries; automotive leasing and renting; waste management; alarm service; construction; clearing house; retailing; real estate development; franchising; real estate management and rental; and business management, among others.

In addition to my practical experience, I have also been an instructor for the California State Society of Certified Public Accountants' continuing professional education programs. I have served as a Quality Review Team Captain for the AICPA.

I passed the examination for Certified Public Accounting in 1976 and currently hold a C.P.A. certificate in the State of California. I am a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants.

I also received a Bachelor of Arts degree in Psychology from California State University, San Diego in 1974.

CERTIFICATE OF SERVICE

I, Sharon E. Mortz, hereby declare under penalty of perjury as follows:

I am employed by David B. Gold, A Professional Law Corporation, 595 Market Street, Suite 2300, San Francisco, California 94105. I am over the age of eighteen years and am not a party to this action.

On November 9, 1992, I served a copy of "EXHIBIT A TO THE DECLARATION OF ALBERT ROSSI, JR." on all parties listed on the attached Exhibit I by causing true and correct copies of same to be enclosed in sealed envelopes and deposited in the United States mail (or as otherwise indicated), addressed as shown on Exhibit I.

Executed this 9th day of November, 1991, at San Francisco, California.

/s/ Sharon E. Mortz
Sharon E. Mortz

EXHIBIT I

SERVICE LIST
(No. C-87-5491 SC)

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Flint & Booth
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27th Floor
San Francisco, CA 94111

ER 516 Ex. 25

ORIGINAL

K MART CORPORATION

INTERNATIONAL HEADQUARTERS
3100 WEST BIG BEAVER RD.
TROY, MICHIGAN 48084

March 28, 1987

AIRBORNE

Mr. Donald Kingsborough
Chief Executive Officer
Worlds of Wonder, Inc.
4209 Technology Drive
Fremont, CA 94538

Dear Mr. Kingsborough:

I am writing to confirm special terms applicable to Blanket Order No. 3, which will be issued to Worlds of Wonder only upon K mart's receipt of a signed copy of this letter and the attached Co-op Advertising Authorization and Specifications form.

1. K mart Corporation (Buyer) will purchase approximately $18,200,000 in Merchandise as specified on Blanket Order No. 3 dated March 28, 1987. The Merchandise will be stored in public warehouses and drawn down by Buyer on an "as needed" basis as follows: Buyer will issue distribution orders to the public warehouse through Worlds of Wonder, Inc. (Seller) from time to time. Seller will oversee the order out of the Merchandise from the public warehouses in order for the Merchandise to arrive at Buyer's "ship to" point by the delivery date specified on each of Buyer's distribution orders. A failure by Seller to cause the delivery date specified on any

distribution order to be met will give Buyer the option of cancelling the Merchandise covered by such order.

2. Title to the Merchandise will pass to Buyer on March 28, 1987; provided, however, risk of loss of or damage to the Merchandise will not pass to Buyer until receipt of the Merchandise by Buyer, from time to time, at Buyer's designated "ship to" points (see also paragraph 7).

3. Buyer will pay the costs of warehousing the Merchandise in public warehouses; provided, however, if such warehousing costs exceed $250,000 or $15,000/month, which ever is greater, Seller will reimburse Buyer the amount of such excess.

4. In consideration of Buyer's early purchase commitment and to assist Buyer in promoting the Merchandise, Seller agrees that Buyer will take a $500,000 deduction against monies due Seller. Seller also agrees that Buyer will take a $250,000 deduction against monies due Seller to cover special handling and inventory charges.

5. Buyer may at its option stock balance any Merchandise shipped under Blanket Order No. 3 which is in its Distribution Center inventory or in the public warehouse inventory on December 31, 1987 on a dollar for dollar basis at the lower of Seller's prices as of March 28, 1987 or Seller's then current prices. Any Merchandise in K mart stores on December 31, 1987 or previously shipped to K mart stores will not be eligible for stock balancing. All stock balancing orders must be issued no later than January 31, 1988 and call for delivery no later than July 31, 1988. Stock balancing orders are limited to Seller's then current product lines. If Seller cannot ship ordered Merchandise by the delivery date specified on the stock balancing order (which date shall be no less

than 30 days from the order date), then Buyer may at its option cancel the order for full credit or refund of the purchase price.

6. All invoices owing by K mart under Blanket Order No. 3 will be passed for payment on December 10, 1987.

7. Seller will pay the freight costs: for the original shipments going into the distribution centers (FOB destination-freight prepaid), for the return of Merchandise being stock balanced (FOB origin-freight collect) and for shipment of stock balancing Merchandise into the distribution centers (FOB destination-freight prepaid). Risk of loss or damage will pass to Buyer, for inbound shipments, upon receipt of the Merchandise by Buyer at Buyer's designated "ship to" points, and to Seller, for outbound shipments, upon Buyer's shipment of the Merchandise back to Seller.

8. Seller will provide counter displays for each new item of Merchandise at all stores at no cost to Buyer and will repair existing store displays at no cost to Buyer.

9. This letter supersedes all prior communications, either written or verbal, with respect to Blanket Order No. 3, including without limitation rough drafts dated March 19, 1987 and April 2, 1987.

10. These terms are in addition to the terms and conditions set forth on the face and reverse of Blanket Order No. 3 and each distribution and stock balancing order issued to Seller thereunder.

11. The attached Co-op Advertising Authorization and Specifications form will apply to all Merchandise ordered under Blanket Order No. 3.

12. Under penalty of perjury, Seller warrants that the allowances granted herein or equivalent alternatives are in fact offered and available on proportionally equal terms to all other competing customers.

Very truly yours,

/s/ T.H. Negolian
/s/ E.J. Scully

AGREED TO as of March 28, 1987 by:

WORLDS OF WONDER, INC.

/s/ Donald D. Kingsborough, Chairman & CEO
By /s/ Angelo M. Pezzani

Title Chief Operating Officer

K mart Corporation

INTERNATIONAL HEADQUARTERS
3100 WEST BIG BEAVER
TROY, MICHIGAN 48084
ORDER CONTRACT
BLANKET ORDER #3

THIS ORDER CONTRACT NOT
AUTHORIZED BY K MART
UNLESS COUNTERSIGNED AT
INT'NAT'L HDQRS.

ORIGINAL
MAIL INVOICE AND BILL OF
LADING TO STORE
GOODS ARE SHIPPED

DATE March 28, 1987
SHIP TO K mart CORPORATION

Vendor Worlds of Wonder

Street 4245 Technology

City Fremont, CA 94538

NOTE – INVOICES FOR SHIPMENTS MADE AGAINST THIS ORDER SHOULD INDICATE ORDER DATE. DATE OF SHIPMENT AND FOR Dept. #4

Shipping schedule and quantities may be changed at Buyer's discretion. This order applies to all Distribution Centers and direct store shipments. Purchase orders will

be sent by Re-buyer for each Distribution Center on an "as needed" basis.

VIA Route Guide

F.O.B. Destination, Freight Prepaid
TERMS Net-December 10, 1987
SHIP To Arrive By Delivery Dates on Distribution Orders
CANCEL at Buyer's Option if Delivery Dates Not Met

ITEM	QUANTITY/ ONLIES	PRICE
Teddy Ruxpin	80,000	$45.78
Grubby	25,000	40.61
Teddy Ruxpin Book & Tape	200,000	7.22
Teddy Ruxpin Clothing	50,000	7.89
Talking Mickey Mouse	50,000	55.90
Mickey Book & Tape	100,000	7.22
Talking Mother Goose	30,000	54.50
Mother Goose Book & Tape	60,000	7.22
Laser Tags	200,000	36.10

ADDITIONAL TERMS AND CONDITIONS

Seller and K mart Corporation ("Buyer") agree to be bound by all terms and conditions contained or incorporated herein, all of which are a part of this Order Contract and should be carefully read. Any provisions in Seller's invoices, billing statements, acknowledgment forms or similar documents which are inconsistent with the provisions of this Order Contract shall be of no force or effect.

1. SELLER'S ACCEPTANCE. Seller's commencement of or promise of shipment of the Merchandise shall constitute Seller's agreement that it will deliver the Merchandise in accordance with the terms and conditions of the Order Contract. Seller agrees to follow the shipping and invoicing instructions issued by Buyer's stores, warehouses, shipping offices and Traffic and Accounting Departments, which instructions are incorporated by reference into this Order Contract.

2. SELLER'S REPRESENTATIONS AND WARRANTIES. Seller represents and warrants to Buyer, in addition to all warranties implied by law, that each item of merchandise described on the face hereof, together with all related packaging and labeling and other material furnished by Seller ("Merchandise") shall (a) be free from defects in design, workmanship or materials including, without limitation, such defects as could create a hazard to life or property; (b) conform in all respects with all applicable federal, state and local laws, orders and regulations, including but not limited to those regarding occupational safety and health; (c) not infringe or encroach upon Buyer's or any third party's personal, contractual or proprietary rights, including patents, trademarks, copyrights, rights of privacy or trade secrets; (d) conform to all of Buyer's specifications and to all articles shown to Buyer as Merchandise samples.

3. SELLER'S INDEMNIFICATION OF BUYER. Seller agrees to reimburse, indemnify, hold harmless and to defend at its expense (or to pay any attorney's fees incurred by Buyer) K mart Corporation and its subsidiary companies against all damage, loss, expense, claim, liability or penalty, including (but not limited to) claims of infringement of patents, copyrights,

trademarks, unfair competition, bodily injury, property or other damage, arising out of any use, possession, consumption or sale of said Merchandise and from any failure of Seller to properly perform this Order Contract. Seller shall obtain adequate insurance to cover its liability under this Order Contract and shall provide copies of the applicable certificate(s) of insurance upon request of Buyer.

4. DEFECTIVE OR NON-CONFORMING MERCHANDISE. If any Merchandise is defective, unsuitable, does not conform to all terms of this Order Contract and all warranties implied by law, Buyer may at its option return it to Seller for full credit or refund of the purchase price or repair it at Seller's expense, and may charge Seller such price or expense and the cost of any incurred inbound and outbound freight and a handling, storage and inspection charge of 7½% of the returned Merchandise' invoice price.

5. BUYER'S RIGHT TO CANCEL. Buyer may terminate and rescind all or part of the Order Contract in the event Seller breaches or fails to perform any of its obligations in any material respect, or in the event Seller becomes insolvent or proceedings are instituted by or against Seller under any provision of any federal or state bankruptcy or insolvency laws or Seller ceases its operation. Time is of the essence to this Order Contract, and Seller's failure to meet any delivery date shall constitute a material breach of the Order Contract.

6. SPECIAL FEATURES. All Merchandise designs, patents and tradenames which are supplied by Buyer to Seller or which are distinctive of Buyer's private label merchandise ("Special Features") shall be the property of Buyer and shall be used by Seller only for Buyer. Buyer may use the Special Features on or with respect to goods manufactured by others and obtain

legal protection for the Special Features including, without limitation, patents, patent designs, copyrights and trademarks.

7. DEDUCTIONS AND SET OFF. Any sums payable to Seller shall be subject to all claims and defenses of Buyer, whether arising from this or any other transaction or occurrence, and Buyer may set off and deduct against any such sums all present and future indebtedness of Seller to Buyer. Buyer shall provide a copy of the deduction voucher(s) for debits taken by Buyer against Seller's account as a result of any returns or adjustments. Seller shall be deemed to have accepted each such deduction unless Seller, within 90 days following receipt of the deduction voucher, notifies Buyer in writing as to why a deduction should not be made and provides documentation of the reason(s) given. Such written notice shall be directed to: Vendor Audit Department, K mart Corporation, 3100 West Big Beaver Road, Troy Michigan 48084.

8. MICHIGAN CONTRACT AND JURISDICTION. This Order Contract shall be construed and enforced in accordance with the laws of the State of Michigan, and it is mutually agreed that either Seller or Buyer shall exercise any right or remedy hereunder in the State of Michigan Courts of Oakland County, Michigan or the United States District Court in Detroit, Michigan.

9. MISCELLANEOUS. (a) All rights granted to Buyer hereunder shall be in addition to and not in lieu of Buyer's rights arising by operation of law; (b) any provisions of this Order Contract which are typewritten or handwritten by Buyer shall supersede any contrary or inconsistent printed provisions; (c) no modification of terms of this Order Contract shall be valid unless in writing and signed by Buyer; (d) should any of the provisions of this Order Contract be

declared by a court of competent jurisdiction to be invalid, such decision shall not effect the validity of any remaining provisions; (e) all of the terms herein shall apply to additional quantities of Merchandise ordered by Buyer except to the extent covered by a new written agreement; (f) the cost price set forth in this Order Contract includes the cost of manufacturing, packaging, labeling and shipping unless otherwise specified herein.

* * *

ER 517 Ex. 27

INTEROFFICE MEMO **WOW**
WORLDS OF WONDER

CONFIDENTIAL

DATE June 29, 1987
TO Angelo Pezzani

FROM Dick Stein
RE **JUNE MPS**

When we signed the June MPS on Thursday of last week, I mentioned to you the financial risk that might arise from this MPS and the recent forecasts of the base and opportunity cases for fiscal 1988. This memo is a follow-up on that discussion in order to give you more specific details for you to take into consideration in your contingency planning.

In both of the forecasts, cash flow requirements in November and December of 1987 and January of 1988 exceed the maximum bank financing available to us under the bank proposals we are presently considering. November is the worst month, where we exceed our bank financing capabilities by $50,000,000. The financing of $63,000,000 of dating is included in the figures. The other financial risk is inventory. If we build inventory to the opportunity sales forecast and only achieve the base case sales, we will end up with $40,000,000 of additional inventory, $135,000,000 in total, at March 31, 1988. We could mitigate this risk somewhat by cutting back our MPS in subsequent months.

With the above in mind, I will start to examine our future financing options.

RBS:bsm

cc: Donald Kingsborough

SIGNATURE /s/ Dick

ER 518 Ex. 97

KMART CORPORATION
INTERNATIONAL HEADQUARTERS
3100 WEST BIG BEAVER RD.
TROY, MICHIGAN 48084

May 6, 1987

Worlds of Wonder
4245 Technology Drive
Fremont, CA 94538

Attn: Mark Bradlee

Dear Mark:

As a follow up to our recent visit, please advise when you think you will be able to sell off the 100,000 pieces of Lazer Tag we discussed at our meeting.

We are most anxious to have our total quantities reduced by this amount due to the lack of movement of the 51,000 pieces we currently have on hand.

Please advise at your earliest convience [sic].

Sincerely,

K MART CORPORATION

/s/ K. A. MacVay
K. A. MacVay, Buyer
Per: G. A. Colgan, Sr. Buyer

KAM:jaq

CC: E. J. Scully
G. A. Colgan
Phil Rosenberg ✔

ER 518 Ex. 99

Toys "R" Us, Inc.
395 West Passaic Street
Rochelle Park, NJ 07662

Howard W. Moore
Executive Vice President
General Merchandise Manager
(301) 368-5440

July 15, 1987

Mr. Don Kingsborough
Worlds of Wonder
4245 Technology Drive
Fremont, California 94538

Dear Don:

This letter is to reiterate the ongoing problems that we are both facing on our inventory.

We are overstocked on the following items:

	Quantity	Last Weeks Sales
1) Talking Snoopy	23,374	49
2) Snoopy Tapes	108,674	165
3) Mother Goose	33,354	307
4) Mother Goose Tapes	231,640	750
5) Laser Tag	193,000	919
6) Laser Tag Accessories:		
– Vest	42,692	139
– Sensor	9,993	177
– Helmet	35,931	70
– Cap	49,453	126
7) Pamela Dolls	28,016	200

8) Pamela Tapes:		
– Camping	5,093	13
– Zoo	8,286	32
– Beach	7,783	43
– Shopping	4,556	13
– Dinner	4,599	19
– BD Party	9,277	49
9) Pamela Outfits	26,493	106

I understand that you are promoting Snoopy and that this situation "may" work its way out. The Snoopy and Mother Goose tapes are a major probem [sic] that will not go away.

The Laser Tag accessories seem hopeless. The Pamela situation has to be addressed for this Christmas, as we discussed.

We would like to take action on these as soon as possible. Please advise me of your latest thinking on these items so we may incorporate any new prices in our roto advertising.

Kindest personal regards.

/s/ Howard
Howard W. Moore

HWM:jmd

ER 518 Ex. 100

(Logo) **Mattel Toys Memo**

TO: Riv Hight
WOW – Hong Kong

DATE: June 24, 1987

FROM: Chris Willson-White

REFERENCE: 022

SUBJECT: LAZER TAG EUROPE

I have just returned from a trip through Europe and was most concerned to hear rumors in all markets of imminent mark downs and subsequent close-out of Lazer Tag in the U.S.

Good trade sources were reporting that WOW has 600,000 Lazer Tag game kits in the U.S. and a further 400,000 Orient commitment, which will result in Lazer Tag being the "close-out of the decade."

Obviously, if you are planning a close-out, we have no objection as far as the U.S. is concerned, but if any of the product reaches International markets, it will have a major detrimental effect on our volume and, of course, kill any profitability.

We had a report that a number of Italian wholesalers had been offered product at a price which would permit a retail price of $25-30 versus our retail of $79.

This situation is worrying and we already face a problem since Photon is being closed-out throughout Europe (in the U.K., for instance, the game kit is already cut from £49.95 to £29.95 . . . with further reductions imminent). This is clearly making us look ridiculously expensive,

and to advertise at the moment would only succeed in achieving sales for Photon.

Riv, I would appreciate your comments and input, since I need to give direction to our Affiliates.

Best regards.

CWW/jmp

cc: Don Kingsborough (WOW Fremont)
Robert Marick
Lindsey Williams

ER 518 Ex. 98

INTEROFFICE MEMO **WOW**
WORLDS OF WONDER

DATE July 6, 1987
TO Don Kingsborough/Bob Goldberg

FROM Ross Heil
RE Lazer Tag Program – Response to Concerned Retailers

The following recommendation is designed to immediately respond to mounting retailer concerns of slow Lazer Tag movement and their substantial inventories.

Objectives

- Maintain current retail pricing, discouraging any serious price cutting
- Build confidence in retailers that we are concerned and are taking immediate action to stimulate movement
- Convince retailers that we have a "grand plan" to make this year's sales even bigger than last.

Strategy

- Select a representative sample of markets as a test and immediately move to increase advertising weights in those markets.
- Follow the test with a heavy-up introduction with new Lazer Tag creative.
- Create a themed selling piece as part of the re-introduction package.

Implementation

- July 8 – Announce test details to all sales reps 3 week heavy weight test in 4 markets
- July 9 – Letters to each major account announcing the test and pledging our commitment
  - Test to begin week of August 3rd. ("It will take us that long to purchase time/coordinate test")
- July 15 – Sales letter to all major accounts:
  - Media schedules by market
  - Toy Tracs study results (graphic/charts) showing desire for Lazer Tag

SIGNATURE /s/ Ross Heil/MK

  - Summary of reports showing increased sales of Lazer Tag at numerous accounts
- August 3 – Begin airing 300 GRP's in test markets end of that week, entire following week and through mid week of following week. (2 weeks over 3)
- August 10 – Report to key retailers of results from first week (repeat for next 2 weeks)
- August 17 – Report #2
- August 24 – Report #3
- August 31 – Complete test results Break plans for major Fall launch:

- New Lazer Tag commercial, "Hotter than ever!"
- Media plan reflecting 4 week intro weights @ 300 GRP's based on test results
- Full color sales brochure with complete program details including:
  - media schedule through the end of 1987
  - Promotion programs with college tournaments and Boys Clubs of America
  - Semi-spectacular display suggestions

- September 12 – National PR event to re-focus attention on Lazer Tag
- September 15 – New commercial begins to air at 300 GRP's

NEXT STEPS: I propose a Re-intro Team be organized with one member each from: Sales, Product Management, Manufacturing, Administration and Graphics/Point of Sale. The Team will need to:

- Implement and monitor each element of the plan
- Recommend program changes based on market response
- Prepare a weekly status report to management
- Coordinate and provide to Sales detailed material for their communication with retailers

I believe that a weekly dialogue with retailers, and our reps, will demonstrate our dedication to the task.

Please let me know if you'd like to discuss this proposal in greater detail.

Thanks

RFH:mk

cc: Janice Kimball, Dave Ruckert, M. Bradlee, A. Pezzani

(ATTACHMENTS TO THE MEMORANDUM)

(Logo) ***TSC Top Sales Company, Inc.***

June 30, 1987

Mr. Dave Ruckert FEDERAL EXPRESSED 6/30/87
WORLDS OF WONDER
Graybridge Division
4209 Technology Drive
Fremont, California 94538

Dear Dave:

Mike Vann at Rose's is very upset with us. When we had the meeting in New York, you told Rose's you would get back with them to set up the Lazer Tag Test in Florence, South Carolina, and Bluefield, West Virginia.

As of this date, he has not heard anything from any of us, and we need to do something. Rose's has a serious overstock on Lazer Tag, and Don Kingsborough made the commitment to find out what TV would do.

I would appreciate it if you would get back to us so we can let Rose's know something.

Sincerely,

TOP SALES COMPANY, INC.

/s/ Felix S. Sabates
Felix S. Sabates

FSS/bd

cc: Mark Bradlee
Jim Whims
Sal Morabito

INTEROFFICE MEMO **WOW**
WORLDS OF WONDER

DATE July 1, 1987
TO Bob Goldberg

FROM Dave Ruckert
RE Summary of Action Items/Mini-Toy Fair

Following summarizes actions promised at the mini-Toy Fair meetings:

1. **Lazer Tag**

A. **Roses** – Two small city tests of high level media (250-350 GRP's/week) full in-store, one at $29.95 and one at current $39.95.

ACTION: Decision to only run at $39.95 must be communicated to Roses through Sal Morabito. Market(s) must be selected and media test implemented.

B. **Lionel Leisure** – Requested high level media test in one of their markets.

ACTION: If WOW agrees to test, market must be selected and test implemented. Co-ordinate through Sal.

C. **Walmart** – Tulsa selected for media/T-shirt test by them 6/30/87. They will buy time and bill us.

ACTION: Co-ordinate through Mike Needleman. Price to be rolled back to $39.95 by Walmart.

D. **Target** – Won't order Lazer Tag line extensions until current product starts to sell.

ACTION: I suggest using a Target market for a media heavy up this summer.

E. **Circus World** – Very upset about Lazer Tag. I was with another account during DK discussions with them.

ACTION: Find out if DK promised media or promotion test, but seems like a good idea to include a CW market for heavy up media.

SIGNATURE _____

ER 519 Ex. 101

(Logo)

BRENNAN
HOWARD

REPRESENTING LEADING
MANUFACTURERS

June 19, 1987

Mr. Carl Crosier
Worlds of Wonder, Inc.
1313 Lyndon Lane
Suite 109
Louisville, Kentucky 40222

Dear Carl,

Per your request, please find our "First Quarter Goal Recap" attached. As you can see, we have been able to move some July orders up for June shipment.

However, following are a few comments in response to your last few memos:

1) First of all, why didn't we know until the 3rd week in May that we had a first quarter quota?

2) Somebody has their head in the sand if they think, as your last memo states, that product is "in demand at this time of year". It is true that merchandise is still selling; however, not at Xmas time rates. I don't think we (WOW) alone are going to change the toy buying habits of the consumer.

3) We should not have to remind you that we have more than enough inventory already out at retail. For example, following are inventory levels and sell-thru numbers on key items at Gold Circle:

ITEM	5/31 INVENTORY		MAY SALES	
Lazer Tag	21,838	Units	164	Units
Teddy	10,647	"	84	"
Grubby	3,062	"	18	"
Teddy Books & Tapes	29,814	"	67	"
Teddy Clothes	5,470	"	87	"
Moother [sic] Goose	2,376	"	9	"
Mickey Mouse	5,754	"	9	"

BRENNAN and HOWARD, INC.
3030 W. Market St., Akron, Ohio 44313
(215) 867-7550

No. 95-154

(3)

Supreme Court, U.S.
FILED
AUG 28 1995
CLERK

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

(1) Did the Ninth Circuit properly apply the principles set forth in *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), to the facts of this case in determining that plaintiffs failed to present sufficient probative evidence of a material misstatement or omission in the Prospectus?

(2) Did the Ninth Circuit properly apply settled summary judgment standards to the facts of this case in granting summary judgment in favor of defendants on the issue of scienter, where plaintiffs presented no direct evidence of scienter and the defendants presented direct evidence that their overall conduct was inconsistent with the speculative inferences urged by plaintiffs?

(3) Did the Ninth Circuit properly apply settled summary judgment precedent in rejecting speculative inferences urged by plaintiffs where the direct evidence rendered such inferences unreasonable?

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Supreme Court Rule 10 5

Respondents/defendants Donald D. Kingsborough, Angelo M. Pezzani, and Richard B. Stein (the "Officers") file this brief in opposition to the Petition for Writ of Certiorari ("Pet.") filed by Petitioners Rosetta Miller, Walter Untermeyer, Alan Nisselson, Trudy Whitman Nisselson, Paul Greenstein, Howard H. Weston, as trustee for the Florida Municipal, Inc., Restated Defined Benefit Trust and Plan, and Sylvia Wind ("Plaintiffs").

I. STATEMENT OF THE CASE

A. Facts

Worlds of Wonder ("WOW") was founded in March 1985 to manufacture and sell Teddy Ruxpin, an animated story-telling bear. Teddy Ruxpin began shipping in August 1985 and was the nation's best selling toy for that Christmas season. WOW recorded net sales of $93 million in its first full fiscal year ended March 31, 1986. WOW's second major product, Lazer Tag, became the best selling toy in the 1986 Christmas season, while Teddy Ruxpin maintained its popularity, giving WOW two of the best selling toys of the season. For the fiscal year ended March 31, 1987, WOW had net sales of approximately $327 million. (A3).[1]

At the February 1987 New York Toy Fair, WOW introduced its new product lines and extensions of existing products to a favorable reception. Based on the indications of interest and orders from customers following Toy Fair, WOW's sales and marketing departments projected

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[1] References to the appendices bound with Plaintiffs' petition are styled "(A___)."

sales of $700 million to $800 million for fiscal year 1988, beginning April 1, 1987. WOW's fiscal year 1988 financial plan, which was approved by WOW's Board in April 1987, conservatively projected net sales of $542 million. (A25).

In order to finance the expanded product development and manufacturing needed to meet the anticipated demand for the company's products, on June 4, 1987, WOW conducted an $80 million public offering of convertible debentures. The risk disclosure in the Prospectus was so extensive that the two major rating agencies, Moody's and Standard & Poors, rated the debentures as below investment grade, *i.e.*, "junk bonds," meaning that the debentures carried a severe risk of default. The marketplace clearly understood the investment risks, for it demanded a yield on the debentures that reflected the substantial risk entailed by their purchase. The interest rate on the debentures was 50% higher than the prevailing rate for investment grade corporate debentures. (A3-A4).

Although Lazer Tag sales in April-May 1987 had declined from Christmas levels, management believed that this was due to the normal seasonality (the April-June quarter is traditionally the weakest in the toy industry) and to WOW's decision, on the advice of outside consultants, to withdraw Lazer Tag advertising temporarily after a boy playing with Lazer Tag was accidentally shot by a Los Angeles area law enforcement officer in April 1987. WOW planned to resume advertising in the Fall of 1987 and projected strong Lazer Tag sales for all of fiscal 1988. For a variety of reasons, however, WOW's expectations were not met. Disappointing sales for the

1988 Christmas season (beginning in September and October) combined with the substantial expenses incurred in increasing production to meet the expected but unrealized demand, caused severe cash difficulties. WOW filed for bankruptcy on December 21, 1987.

B. Proceedings Below

The District Court granted the motion of the Officers and other defendants for summary judgment. *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850 (N.D. Cal. 1993).[2] The Ninth Circuit affirmed summary judgment for the Officers, directors and underwriters, holding that the

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[2] The Ninth Circuit noted that the district court's grant of summary judgment in 1993 occurred "after a tortured five years of proceedings." (A5 (citing *In re Worlds of Wonder Sec. Litig.*, 694 F. Supp. 1427 (N.D. Cal. 1988) (dismissing Plaintiffs' complaint); *In re Worlds of Wonder Sec. Litig.*, 721 F. Supp. 1140 (N.D. Cal. 1989) (dismissing in part Plaintiffs' amended complaint); *In re Worlds of Wonder Sec. Litig.*, [1989-90 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,004 (N.D. Cal. 1990) (certifying Plaintiffs' class); *In re Worlds of Wonder Sec. Litig.*, [1990-91 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689 (N.D. Cal. 1990) (denying shareholders' motion for summary judgment); *In re Worlds of Wonder Sec. Litig.*, [1992 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,018 (N.D. Cal. 1992) (granting Plaintiffs' motion to quash); *In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 208 (N.D. Cal. 1992) (denying Officers' motion to quash Plaintiffs' subpoena to Securities Exchange Commission); *In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 214 (N.D. Cal. 1992) (denying Plaintiffs' motion to compel Deloitte to produce internal audit manuals))). After the Ninth Circuit panel affirmed the District Court's grant of summary judgment, Plaintiffs petitioned for rehearing and suggested the appropriateness of rehearing *en banc*, which petition also was denied.

debenture Prospectus was not materially misleading as a matter of law.[3] The Ninth Circuit held that the risk disclosure warned investors that the toy industry and WOW's sales were highly seasonal, with the majority of sales occurring in the Christmas season; that WOW would be adversely affected by a seasonal sales shortfall; that internal controls had continually lagged behind WOW's growth; and that WOW's cash position was precarious and that the company would need additional bank credit. The panel also found that Plaintiffs failed to provide probative evidence that the Prospectus contained any material misstatement or omission concerning WOW's existing sales practices, liquidity, or internal controls. (A14-A28).

With respect to the Rule 10b-5 claim, the Ninth Circuit held that the Class had not presented probative evidence of scienter, and that the defendants' overall conduct – including the post-offering expansion of the Company, the disclosure of adverse information, and minimal stock sales – negated an inference of scienter. (A39-A40).

II. SUMMARY OF ARGUMENT

The Petition primarily concerns the Ninth Circuit's holding with respect to the outside auditors, Deloitte &

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[3] The panel affirmed in part and reversed in part as to the outside auditors. The panel affirmed summary judgment for the auditors on the Rule 10b-5 claim, holding that Plaintiffs had not provided sufficient evidence of scienter. The panel reversed summary judgment in favor of the auditors on the Section 11 claim, and remanded those claims for trial.

Touche ("Deloitte"), and the Court's application of summary judgment standards to Plaintiffs' claims against Deloitte. To the extent that the Petition addresses the claims against the Officers, Plaintiffs provide no basis for this Court to grant a writ of certiorari.

Plaintiffs do not challenge the legal principles applied by the Ninth Circuit. Instead, they claim that the Ninth Circuit *misapplied* those principles to the facts of this case, resulting in the wrong holding. Plaintiffs thus urge this Court to review the factual and evidentiary arguments that were thoroughly considered and rejected by the courts below. But Plaintiffs' dissatisfaction with the Ninth Circuit's fact-bound application of settled law, without more, is not an appropriate basis for Supreme Court review. *See Rice v. Sioux City Memorial Park Cemetery, Inc.*, 349 U.S. 70, 79 (1955) (stressing the importance that the Court not grant a writ of certiorari " 'except in cases involving principles the settlement of which is of importance to the public as distinguished from that of the parties, and in cases where there is a real and embarrassing conflict of opinion and authority between the circuit courts of appeal.' ") (quoting *Layne & Bowler Corp. v. Western Well Works, Inc.*, 261 U.S. 387, 393 (1923)); *see also* Sup. Ct. R. 10. Further, Plaintiffs' arguments that the Ninth Circuit misapplied the law and that its resulting holding conflicts with the decisions of this Court and the other Circuit Courts are based solely on mischaracterizations of the factual and legal bases for the Ninth Circuit's decision.

Plaintiffs' factual misstatements permeate their Petition. Plaintiffs make the same evidentiary arguments that were considered and rejected by the Ninth Circuit and

the district court. After reviewing the evidence presented by the Plaintiffs below, the Ninth Circuit determined that the evidence did not support Plaintiffs' factual assertions. The Ninth Circuit held that WOW's difficulties with its internal controls had been adequately disclosed; that there was no "collapse" in sales at the time of the offering; that WOW was not experiencing a "liquidity crisis" at the time of the debenture offering; and that WOW did not fail to disclose material information about its sales practices. The evidence supporting these findings was thoroughly discussed in the Ninth Circuit's opinion. (A14-A28); *see also* Section I(A), *supra*.

Plaintiffs also misstate three separate aspects of the Ninth Circuit's holding: 1) the manner in which the Ninth Circuit reached its determination that the debenture Prospectus contained no materially misleading statements; 2) the Ninth Circuit's holding regarding scienter; and 3) the manner in which the Ninth Circuit applied well-settled summary judgment standards.

Plaintiffs challenge the Ninth Circuit's application (but not adoption) of the "bespeaks caution" doctrine. Plaintiffs assert that the Ninth Circuit held that risk disclosure *per se* "immunizes material misrepresentations or omissions of *existing facts*." Pet. at 25. To the contrary, the Ninth Circuit, after thoroughly reviewing the evidence, held that the Prospectus contained no material misrepresentations or omissions of existing fact. That determination was based on a measured and fact-specific application of settled law in a manner that was wholly consistent with Supreme Court precedent and the decisions of the other Circuits.

Plaintiffs also erroneously state that the Ninth Circuit ignored Plaintiffs' evidence of scienter. Rather, the Ninth Circuit, after reviewing all of the facts, held that Plaintiffs had not presented probative evidence of scienter, and that the evidence presented by defendants negated any inference of scienter.

Finally, Plaintiffs assert that the Ninth Circuit "improperly weigh[ed] and resolv[ed] conflicts in the evidence." Pet. at 29. However, the Ninth Circuit thoroughly considered the evidence in light of controlling standards for summary judgment.

III. ARGUMENT

A. There Is No Need For Supreme Court Review Of The Ninth Circuit's Determination That The Prospectus Contained No Material Misrepresentations Or Omissions.

1. The Ninth Circuit Concluded that the Prospectus Contained No Material Misrepresentations or Omissions Based on a Review of the Evidence.

The Ninth Circuit conducted a *"de novo"* review of the evidence and affirmed the district court's determination that the " 'textual part' of the Debenture Prospectus was not materially false and misleading." (A6-A7). In conducting that review, the Ninth Circuit was mindful that materiality is a "fact-specific issue which should ordinarily be left to the trier of fact," but noted that Plaintiffs can defeat summary judgment "only by showing a genuine issue of fact with regard to a particular statement by the company or its insiders." (A6). Thus the

Ninth Circuit separately analyzed each of the claimed misstatements to determine whether Plaintiffs met that burden. (A7; A14-A28).

In *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), this Court noted the importance of considering a claimed misstatement in context. There, this Court observed that "publishing accurate facts . . . can render a misleading proposition too unimportant to ground liability." *Id.* at 1097. In analyzing the claimed material misstatements and omissions in the Prospectus at issue here, the Ninth Circuit similarly held " 'that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved.' " (A7). The Ninth Circuit approved the district court's use of the "rubric of the 'bespeaks caution' doctrine" to describe the above holding (A7), noting that "bespeaks caution" is simply shorthand for the "unremarkable proposition that a statement must be analyzed in context." (A11); *see also In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-73 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994); *Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994).

Plaintiffs do not challenge the bespeaks caution doctrine, conceding that it is " 'merely new nomenclature rather than [a] substantive change in the law.' " Pet. at 24 (citing *Trump*, 7 F.3d at 364). Rather, plaintiffs assert that the Ninth Circuit erred in 1) determining that risk disclosure *"per se"* precludes liability; and 2) holding that risk disclosure "immunizes" material misstatements of existing fact. Pet. at 24, 26. These assertions mischaracterize the Ninth Circuit's opinion.

The Ninth Circuit did not hold, as Plaintiffs assert, that "the mere fact that the Prospectus *addressed* a particular subject foreclosed any claim that the Prospectus was misleading with respect to that subject." Pet. at 26 (emphasis in original). The Ninth Circuit emphasized the need for "precise cautionary language" that was directly addressed to the allegedly misleading misstatement, and specifically held that "blanket warnings" that the securities were risky would be insufficient to avoid liability. (A12). The Ninth Circuit's thorough analysis of the specificity and accuracy of the risk disclosures in light of the evidence also demonstrates that the panel did not apply a *"per se"* rule. (A14-A28).[4]

Plaintiffs also assert that the Ninth Circuit improperly held that risk disclosure "immunizes material misrepresentations and omissions of *existing facts*." Pet. at 25 (emphasis in original). However, Plaintiffs' interpretation of the *WOW* decision is belied by *WOW* itself and was explicitly rejected by the Ninth Circuit's subsequent decision in *Kaplan v. Rose*, 49 F.3d 1363 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3849 (U.S. May 10, 1995) (No. 94-1895). In *Kaplan*, the Ninth Circuit observed that its recent adoption of the "bespeaks caution" doctrine in *WOW* "holds that if 'precise cautionary language . . . directly addresses itself to future projections, estimates, or forecasts in a prospectus,' 'the projections will not give rise to a claim of securities fraud.' " 49 F.3d

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[4] Plaintiffs' references to the Ninth Circuit's analysis of the Prospectus do not support their assertion that the court applied the bespeaks caution doctrine as a *per se* rule. See Sections III(A)(1)(a)-(b), *infra*, and n.3, *supra*.

at 1373. The court in *Kaplan*, however, concluded that the *WOW* decision did *not* eliminate liability for misrepresentations of existing facts or conditions. *Id.* at 1374; *see also In re Valence Technology Sec. Litig.*, No. C94-1542-SC, 1995 WL 274343 at *14, 16 (N.D. Cal. May 8, 1995) (refusing to apply the bespeaks caution doctrine because plaintiffs' allegations "concern existing misrepresentations"); *Whirlpool Fin. Corp. v. GN Holdings*, 873 F. Supp. 111, 124 n.19 (N.D. Ill. 1995); *In re Browning-Ferris Indus. Sec. Litig.*, 876 F. Supp. 870, 879 (S.D. Tex. 1995).

Further, the Ninth Circuit held that Plaintiffs had not presented sufficient evidence showing that the textual disclosure in the Prospectus materially misrepresented WOW's business and financial condition – not that the risk disclosure somehow "immunized" material misstatements of existing fact. The only two examples cited by Plaintiffs, relating to WOW's sales and internal controls, do not support their arguments to the contrary.[5]

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[5] Plaintiffs' argument also references pages 17-19 of their petition, Pet. at 26, which address the alleged evidence regarding WOW's liquidity and WOW's sales practices. In that earlier discussion, Plaintiffs claim that the Ninth Circuit somehow "ignored" their evidence. Pet. at 18. However, the Ninth Circuit thoroughly addressed the evidence presented by Plaintiffs and determined that Plaintiffs' arguments were not supported by the facts.

The Ninth Circuit held that the Prospectus "clearly bespoke caution on the serious risks WOW's liquidity crisis posed to investors." (A15). Making the identical argument that was rejected below, Plaintiffs assert that the Prospectus did not disclose that WOW would supposedly run out of cash "immediately after" the offering. Pet. at 18. However, Plaintiffs relied on only two documents, both of which are dated after the offering: 1) a memorandum from WOW's lender indicating that

The Ninth Circuit conducted a thorough *de novo* review of all the evidence submitted by Plaintiffs in support of those allegations, and determined that the evidence did not support their claims. (A17-A19; A22-A26). Plaintiffs' argument is thus nothing more than a complaint that the Ninth Circuit got the facts wrong. However, that is not an appropriate basis for review by this Court.

WOW had drawn-down on its line of credit; and 2) a memorandum by Mr. Stein speculating that WOW might encounter a cash shortfall in late 1987. (A15-A16). The Ninth Circuit specifically considered both documents, and determined that the documents did not show that WOW was out of cash at the time of the offering. (*Id.*)

Plaintiffs also challenge the Ninth Circuit's factual findings regarding WOW's sales practices. However, as noted by the Ninth Circuit, Plaintiffs themselves "concede[d] that price protection is a common practice in the toy industry," and "the undisputed evidence also indicates that stock balancing is commonplace in the industry." (A20). Accordingly, WOW had no duty under the securities laws to disclose its observance of those practices. (*Id.*) The court also considered Plaintiffs' evidence of supposed guaranteed sales, and reached the factual determination that such evidence was "speculative, nebulous and nowhere purported to quantify the degree to which WOW engaged in this 'normal business' practice." (A29). The Ninth Circuit noted that WOW's auditors had examined WOW's sales practices and concluded that any guaranteed sales "were minimal in number and did not have a material impact on WOW's financial statements taken as a whole." (*Id.*)

a. Sales and demand

Plaintiffs assert that the Prospectus failed to disclose that sales and demand for WOW's products were "collapsing" at the time of the debenture offering. However, the Ninth Circuit carefully examined the specific risk disclosures in the Prospectus and determined that the fact Plaintiffs claim was omitted – that sales for WOW's products had declined – actually was disclosed. As the Ninth Circuit observed, the Prospectus "fully disclosed" 1) a significant decline in both net sales and net income for the first three months of calendar 1987; 2) that WOW expected that sales for the quarter ended June 30, 1987 would be below sales for the prior three quarters; and 3) that the loss for the quarter would be "disproportionally greater" than the year-earlier quarter. (A22-A23). Thus, the Prospectus clearly and specifically disclosed a downward trend in sales and earnings, and the panel did not, as Plaintiffs assert, provide immunity on the basis that the Prospectus merely "addressed" a subject. Pet. at 26.

More importantly, Plaintiffs' evidence did not support their claim that WOW failed to disclose an existing "collapse" in sales and product demand at the time of the offering. Plaintiffs argued that because WOW's sales (primarily for Lazer Tag) in April and May 1987 were below WOW's internal plan for the fiscal year ended March 31, 1988, the Officers should have disclosed that sales were "dead" at the time of the offering. (A24-A25). However, the evidence considered by the Ninth Circuit showed that WOW's Officers, the investment bankers, and retailers all expected that WOW's products would sell well over the coming fiscal year; that WOW's sales performance in

April and May 1987 was "relatively inconsequential," since WOW's internal financial plan projected that sales for those months would account for only four percent of total anticipated revenue for fiscal year 1988 (most toy sales occur at Christmas); and that WOW had commenced a production schedule implementing the corporation's business plan projecting $542 million in sales. (A25). The Ninth Circuit determined that Plaintiffs' evidence did not support their contention that there was a sales crisis at the time of the offering, and indeed, that such a contention was contradicted by the evidence. (A24-A26). Plaintiffs' disagreement with that factual determination provides no basis for this Court to grant a writ of certiorari.

b. Internal controls

Plaintiffs' argument concerning WOW's disclosure of internal controls, (Pet. at 11-12), is particularly ironic given the panel's finding that, if anything, WOW "erred on the side of over disclosure." (A19). In attacking the decision, Plaintiffs misrepresent the Ninth Circuit's holding and again rely on documents and arguments that were thoroughly examined by the courts below.

First, the Ninth Circuit did *not* hold, as Plaintiffs assert, that omissions regarding existing problems with WOW's internal controls were rendered immaterial by the disclosure of future risks. Pet. at 25. Indeed, the Ninth Circuit expressly noted the Prospectus' disclosure that WOW's internal controls had "lagged behind" the Company's growth, and that there was no assurance that efforts to improve internal controls would be successful.

(A17-A18). Similarly, the court noted that the Prospectus "did not state or imply that WOW's internal control problems 'were in the past' and not ongoing." (A18). Thus the Prospectus *did* disclose internal control deficiencies.

Second, Plaintiffs' evidence regarding internal control deficiencies demonstrated that those deficiencies, to the extent they existed at the time of the offering, were immaterial. Plaintiffs relied entirely on Deloitte's management letter that was prepared 2 1/2 months after the offering. The Ninth Circuit, however, noted that the management letter concluded that WOW's internal controls "had no material weaknesses." (A18).

2. The Ninth Circuit's Determination that the Prospectus Contained no Material Misrepresentations or Omissions is Consistent with Supreme Court Precedent and the Decisions of Other Circuits.

Plaintiffs argue that the Ninth Circuit's determinations regarding materiality and the adequacy of the disclosures in the Prospectus conflict with Supreme Court precedent and the decisions of the other Circuits. However, Plaintiffs' argument is premised on their erroneous contention that the Ninth Circuit held that risk disclosure "*per se*" precludes liability, which it did not. *See* Section III (A), *supra*.

As the Ninth Circuit noted, its context-specific approach to analyzing the alleged misstatements was entirely consistent with *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1097 (1991), which held that "while a misleading statement will not always lose its deceptive

edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil." (A12); *see also In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 369, 373 (3d Cir. 1993) ("*Virginia Bankshares* just restates . . . that materiality involves a context-specific analysis such that warnings and cautionary language will sometimes suffice to render the allegedly misleading misrepresentations or omissions immaterial as a matter of law"), *cert. denied*, 114 S. Ct. 1219 (1994). In *Trump*, the Third Circuit noted that its context-specific adoption of the "bespeaks caution" doctrine also was consistent with this Court's decision in *TSC Industries v. Northway, Inc.*, 426 U.S. 438 (1976), and stated that " 'bespeaks caution' is essentially shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law." *Trump*, 7 F.3d at 364.

Similarly, there is no Circuit split on this issue. The Ninth Circuit noted that its definition of the "bespeaks caution" doctrine was supported by "a wealth of authority" from other Circuits and district courts. (A10). Indeed, the Ninth Circuit closely followed the Third Circuit's decision in *Trump*, which is considered the leading decision on the bespeaks caution doctrine. The Ninth Circuit also cited to cases in the First, Second, Fifth, Sixth, and Eighth Circuits adopting the doctrine. (A9-A10); *see Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994); *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir. 1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991); *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir.

1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991). Since the Ninth Circuit's decision in *WOW*, the bespeaks caution doctrine also has been adopted by the Eleventh Circuit in *Saltzberg v. TM Sterling/Austin Assocs.*, 45 F.3d 399 (11th Cir. 1995).

None of the courts citing the Ninth Circuit's adoption of the "bespeaks caution" doctrine in *WOW* has held that *WOW*'s approach to the "bespeaks caution" doctrine was inconsistent in any material manner from decisions of the other Circuits. *See Kaplan v. Rose*, 49 F.3d 1363, 1373 (9th Cir. 1994); *In re Valence Technology Sec. Litig.*, 1995 WL 274343 at *14, 16; *Whirlpool Financial*, 873 F. Supp. at 124 n.19; *Browning-Ferris*, 876 F. Supp. at 879, 882.

The cases cited by Plaintiffs are not to the contrary. Plaintiffs' suggestion that the Ninth Circuit's decision is inconsistent with *Rubinstein* again is based on their erroneous contention that the Ninth Circuit held that risk disclosure *"per se"* immunizes misstatements or omissions. The Fifth Circuit in *Rubinstein* did not reject a context-specific approach to analyzing risk disclosure, but held only that the district court erred in applying a *per se* rule that economic forecasts and predictions may *never* form the basis for securities fraud when couched in cautionary language. 20 F.3d at 167. The Fifth Circuit did not reject more fact-specific applications of the bespeaks caution doctrine, such as that applied by the Ninth Circuit. *Id.* Indeed, the Ninth Circuit cited *Rubinstein* as providing an explanation of the doctrine. (A10-A11).

Similarly, in *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir. 1993), which was decided on a motion to dismiss, the Sixth Circuit held only that risk disclosure does not *per se*

cure the misleading nature of alleged misstatements. In *Mayer*, the Sixth Circuit clarified and narrowed its earlier decision in *Sinay v. Lamson & Sessions Co.*, which the *Mayer* court feared could have been interpreted as holding that economic projections coupled with cautionary statements were *per se* non-actionable. *Mayer* held, at the pleading stage, that it was necessary to "weigh" the evidence against the risk disclosure. In *WOW*, however, the Ninth Circuit, after extensive discovery, held that the disclosure in the Prospectus was not misleading in light of all the evidence. *WOW* is entirely consistent with *Mayer*, given that the Ninth Circuit, like the Sixth Circuit, refused to establish a sweeping rule that cautionary statements will always render misrepresentations or omissions immaterial as a matter of law. *See also Trump*, 7 F.3d at 373 n.16 (discussing *Mayer*).

Pommer v. Medtest Corp., 961 F.2d 620 (7th Cir. 1992), is similarly inapplicable. *Pommer* held merely that "boilerplate" and "generic" warnings that did not address the subject matter of the alleged false statements would be insufficient to avoid liability. *Id.* at 624-25. The Ninth Circuit similarly noted that "blanket warnings" are insufficient, citing *Kline v. First Western Government Securities*, 24 F.3d 480, 489 (3d Cir.) ("application of the 'bespeaks caution' doctrine . . . requires that the language bespeaking caution relate directly to that by which plaintiffs claim to have been misled"), *cert. denied*, 115 S. Ct. 613 (1994). (A12).

Plaintiffs' argument that the Ninth Circuit's decision is inconsistent with the decisions of this Court and the other Circuits is clearly wrong. That argument is based solely on Plaintiffs' misstatement of the bases for the

Ninth Circuit's opinion, a misstatement that is readily apparent from the text of the opinion. The Ninth Circuit expressly rejected the application of the bespeaks caution doctrine that Plaintiffs contend it adopted; the Ninth Circuit instead adopted a "context-specific approach," which "applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts." This approach is wholly consistent with the decisions of other Circuits.

B. The Ninth Circuit's Holding On Scienter Was Based On The Specific Facts In This Case.

To withstand summary judgment on the issue of scienter, plaintiffs must present sufficient probative evidence of a "mental state embracing an intent to deceive." *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, *reh'g denied*, 425 U.S. 986 (1976). Thus, in analyzing the WOW defendants' motions for summary judgment on the issue of scienter, the Ninth Circuit looked at the facts presented by Plaintiffs to determine whether they met that evidentiary burden. The Ninth Circuit found that the Plaintiffs failed to present *any* direct evidence of scienter, and that the inferences that they sought based on circumstantial evidence were unreasonable. The Ninth Circuit thus concluded, based on the facts in this case, that Plaintiffs had not made the required evidentiary showing. Plaintiffs' contention that the Ninth Circuit's holding dictates that summary judgment on the issue of scienter be granted

regardless of the strength of the evidence submitted by plaintiffs is erroneous. Pet. at 3, 20.[6]

Plaintiffs make conclusory allegations that the Officers "knowingly made false public statements"; "sold massive quantities of WOW stock"; "failed to disclose material adverse facts known to them"; and "were aware of bogus financial transactions." Pet. at 27. However, those identical allegations were fully considered and rejected by the Ninth Circuit and the district court after a careful review of the evidence. (A38-A39). The Ninth

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[6] Plaintiffs also challenge the Ninth Circuit's holding regarding the auditors' alleged scienter, claiming that the court held that "a § 10(b) plaintiff can *never* get to the jury on the *scienter* issue, no matter how strong his evidence of fraudulent intent, knowledge or recklessness, as long as the auditor proffers expert testimony that its accounting determinations were valid." Pet. at 3. However, the court held nothing of the kind. The court held that Plaintiffs had presented no probative evidence of fraudulent intent or recklessness, not that such evidence was outweighed by the opinion of the auditor's expert. Indeed, the court barely mentioned the declaration of the auditor's expert, focusing instead on the *absence* of any evidence presented by Plaintiffs. In so holding, the court fully considered all of the evidence presented by Plaintiffs, carefully reviewed the declaration of Plaintiffs' expert, accepted as true the existence of disputed issues as to whether WOW's audited financial statements failed to comply with generally accepted accounting principles, and correctly held that merely questioning accounting judgments was not sufficient to establish scienter. (A42-A44); *see also In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 627 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3892 (U.S. June 12, 1995) (No. 94-2027); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994); *Malone v. Microdyne Corp.*, 26 F.3d 471, 479 (4th Cir. 1994); *Stamatio v. Hurco Cos., Inc.*, No. IP 94308C, 1995 WL 431916, at *2 (S.D. Ind. July 18, 1995); *In re In-Store Advertising Sec. Litig.*, 878 F. Supp. 645, 648-49 (S.D.N.Y. 1995).

Circuit's fact-based application of settled law is not an appropriate issue for Supreme Court review.

Plaintiffs also assert that the Ninth Circuit erroneously held that "persons [such as officers, directors, underwriters and controlling persons] can 'conclusively' rebut *scienter*" merely by submitting certain evidence. Pet. at 4, 37. First, regardless of whether there was evidence "rebutting" scienter (which there was), defendants are not required to prove the absence of scienter; rather plaintiffs must present sufficient probative evidence of scienter. *See Matsushita Elec. Indus. Co. v. Zenith Radio, Corp.*, 475 U.S. 574, 587, 596-97 (1986). Here, the Ninth Circuit held that Plaintiffs "produced no direct evidence of any scienter." (A39). To the extent Plaintiffs contend that the Ninth Circuit's holding applies to cases in which plaintiffs actually meet their evidentiary burden with regard to scienter, they are wrong. The Ninth Circuit was not presented with such a case, and its opinion does not address that hypothetical situation.

Plaintiffs also argue that the Ninth Circuit's holding in this case conflicts with the holdings of other Circuits. However, that argument hinges on Plaintiffs' obviously erroneous (and unsupported) assertion that the Ninth Circuit held that "a corporate insider can trade with impunity as long as he retains most of his stock." Pet. at 27. Here, Plaintiffs presented no evidence of insider trading. Instead, Plaintiffs attempted to infer scienter for all of the Officers based on Mr. Kingsborough's sale of a fraction of his stockholding in late July 1987. The Ninth Circuit rejected such an inference, because 1) Mr. Kingsborough's sales occurred *after* the disclosure of disappointing results for the June 30, 1987 quarter and well

before WOW's problems in late 1987; 2) the other Officers, Messrs. Pezzani and Stein, sold *no* stock prior to WOW's collapse; and 3) Mr. Kingsborough retained the vast bulk of his stockholdings. The Ninth Circuit properly held that this evidence negated the "inference of scienter" urged by Plaintiffs on the basis of Mr. Kingsborough's sales. (A40 (citing *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) ("credible and wholly innocent explanations for the stock sales . . . are sufficient to defeat any inference of bad faith"))). *Accord Acito v. IMCERA Group*, 47 F.3d 47, 54 (2d Cir. 1995); *Thornton v. Micrografx*, 878 F. Supp. 931, 938 (N.D. Tex. 1995).

Plaintiffs similarly mischaracterize the Ninth Circuit's holding regarding the other evidence negating any inference of scienter, which included the Officers' post-offering efforts to continue WOW's expansion and the detailed risk disclosure in the Prospectus. Contrary to Plaintiffs' arguments, the Ninth Circuit did not hold that this evidence provided an absolute bar to liability. Rather, the court held that the overall conduct of the Officers rebutted the "speculative inferences" of scienter sought by Plaintiffs. (A39). Again, the Ninth Circuit's holding was based on the specific facts in this case.

The Ninth Circuit's holding on scienter is entirely consistent with Supreme Court authority and the holdings of the Ninth Circuit and the other Circuits. As this Court stated in *Matsushita*:

> [To survive summary judgment], the nonmoving party must come forward with 'specific facts showing that there is a *genuine issue for trial.*' . . . Where the record taken as a whole

> could not lead a rational trier of fact to find for the non-moving party, there is no 'genuine issue for trial.' . . . It follows from these settled principles that if the factual context renders [the non-movants'] claim implausible – if the claim is one that simply makes no economic sense – [the non-movants] must come forward with more persuasive evidence to support their claim than would otherwise be necessary.

475 U.S. at 587 (citations omitted). Thus, where, as here, speculative inferences based on circumstantial evidence of wrongdoing are contradicted by defendants' overall pattern of conduct, summary judgment is appropriate. *See id.* at 596-97 (where defendants have no motive to engage in wrongdoing and their "conduct is consistent with other equally plausible explanations, the conduct does not give rise to an inference of [wrongdoing]"); *Apple*, 886 F.2d at 1117 (same).

C. The Ninth Circuit Applied The Correct Summary Judgment Standards.

Plaintiffs' argument that the Ninth Circuit applied controlling summary judgment standards improperly to the facts of the case is not appropriate for review by this Court. Indeed, Plaintiffs do not even muster an argument that this Court's review of this issue will affect parties other than those involved in this case. The Ninth Circuit established no new law in this area, relying on well-settled summary judgment principles set forth by the Ninth Circuit in *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 500 (9th Cir. 1992), which were based on this Court's decisions in *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242,

247-48 (1986) and *Matsushita Electric Industry Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986).

Plaintiffs misapprehend controlling authority by asserting that the Ninth Circuit "disregarded" the controlling principles set out in those cases. *See* Pet. at 29 (court found the Class' evidence "not very probative"). Supreme Court and Ninth Circuit precedent *require* that summary judgment be granted when plaintiffs fail to provide "significant probative evidence" to allow a reasonable jury to find in their favor.[7] Thus, the Ninth Circuit was obligated to analyze the evidence to determine whether it was probative of Plaintiffs' allegations.

What Plaintiffs are really asserting is that the panel should have indulged their speculative inferences based on circumstantial evidence. This Court has emphasized, however, that summary judgment may not be defeated by such inferences.[8] In short, the Ninth Circuit applied the appropriate standards for summary judgment.

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[7] *See Anderson*, 477 U.S. at 252-54; *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990); *Smolen v. Deloitte, Haskens & Sells*, 921 F.2d 959, 963 (9th Cir. 1990).

[8] *Matsushita*, 475 U.S. at 587; *see also Hanon*, 976 F.2d at 500; *In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig.*, 906 F.2d 432, 441 (9th Cir. 1990), *cert. denied*, 500 U.S. 959 (1991).

IV. CONCLUSION

For the foregoing reasons, the Officer Respondents respectfully request that the Court deny Plaintiffs' Petition for a Writ of Certiorari.

Respectfully submitted,

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August 28, 1995

Supreme Court, U.S.
FILED
AUG 23 1995
CLERK

No. 95-154

IN THE
Supreme Court of the United States
OCTOBER TERM 1995

ROSETTA MILLER, *et al.*,
Petitioners,

v.

ANGELO PEZZANI, *et al.*,
Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR RESPONDENTS BARRY H. MARGOLIS AND WORLDS OF WONDER SHARES PARTNERSHIP IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Ninth Circuit properly found on the facts before it that the outside auditors, Deloitte & Touche, rebutted scienter?

2. Whether the Ninth Circuit properly applied the principles set forth in *Virginia Bancshares v. Sandberg*, 501 U.S. 1083 (1991) in its application of the "bespeaks caution" doctrine to the facts of this case, following at least six other circuit courts and focussing on the disclosures in the particular prospectus before it?

3. Whether the Ninth Circuit properly applied the law to the particular facts before it to find that the class presented no evidence of scienter with regard to the insider trading allegations?

4. Whether the Ninth Circuit properly applied settled summary judgment precedent in rejecting speculative inferences urged by petitioners where the direct evidence rendered such inferences unreasonable?

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No. 95-154

IN THE

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OCTOBER TERM, 1995

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR RESPONDENTS BARRY H. MARGOLIS AND WORLDS OF WONDER SHARES PARTNERSHIP IN OPPOSITION

STATEMENT

In a carefully reasoned opinion, the Court of Appeals affirmed the District Court's summary judgment opinion as it related to Worlds of Wonder Shares Partnership, an investor, and Mr. Margolis, an outside director of Worlds of Wonder, Inc.. The factual record was correctly reviewed and summary judgment was proper as to these parties. No act or omission by them was shown in the record. Their presence in the case was an abuse of fairness, procedure, and law; they were accordingly dismissed.

The Ninth Circuit held that:

(1) The textual part of the debenture prospectus contained adequate cautionary language and was not false or misleading under the "bespeaks caution" doctrine. The Ninth Circuit further found that petitioners had failed to advance any evidence to support their claims that several sections of the prospectus were misleading.

(2) There was no evidence of scienter to support the charges of insider trading.

REASONS FOR DENYING THE PETITION

Petitioners fail to advance any special or important reason for granting their petition for a writ of certiorari.[1] Petitioners challenge the Ninth Circuit's application of the "bespeaks caution" doctrine but petitioners pointedly ignore the uniform line of court of appeals authority cited by the Ninth Circuit decision itself. The Ninth Circuit did not apply a "per se" rule. Rather, the Ninth Circuit's context-specific approach to the "bespeaks caution" doctrine was entirely consistent with *Virginia Bancshares Inc. v. Sandberg*, 501 U.S. 1083, 1097(1991) and the precedent from other circuits.[2]

Petitioners' other arguments are completely fact-bound in nature and were correctly resolved by the District

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[1] Most of the petition addresses the Ninth Circuit's holding with respect to the auditors Deloitte & Touche. Of the questions set forth above, only questions 2—4 in any way involve Mr. Margolis, and only questions 3—4 even touch upon Worlds of Wonder Shares Partnership.

[2] This issue is briefed in the opposition filed by the respondents Donald D. Kingsborough, Angelo M. Pezzani and Richard B. Stern and is incorporated herein.

Court and the Court of Appeals. Petitioners neither show nor address any evidence of wrongdoing or scienter as to Mr. Margolis or Worlds of Wonder Shares Partnership. Instead, petitioners factually mischaracterize the record, and the Ninth Circuit's holding. The Ninth Circuit found that respondents' actual trading conclusively rebutted any inference of scienter; that petitioners had no evidence to the contrary; and that petitioners could not point to any bit of supposed insider information traded upon. The Ninth Circuit's fact-bound application of settled law is not an appropriate issue for Supreme Court review.

Finally, petitioners' argument that the Ninth Circuit improperly applied controlling summary judgment standards to the facts of the case is not appropriate for review by this Court. In fact, the Ninth Circuit established no new law. Summary judgment was correctly granted, and the Ninth Circuit correctly found that petitioners could not defeat summary judgment based upon speculative inferences. These respondents rest on the record and the complete absence of any showing of wrongdoing. Review by this Court is unwarranted.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

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(5)

Supreme Court, U.S.
FILED
AUG 28 1995
CLERK

In the

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN, HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

RESPONDENT SMITH BARNEY'S BRIEF IN OPPOSITION

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QUESTION PRESENTED*

Did the court of appeals, applying settled legal principles to its *de novo* review of a detailed factual record, properly affirm the district court's summary judgment in favor of respondent Smith Barney, particularly where petitioners did not challenge on appeal Smith Barney's establishment, through undisputed evidence, of its "due diligence" defense to petitioners' claims under the Securities Act of 1933 and the absence of scienter on petitioners' claim under the Securities Exchange Act of 1934?

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* The remaining questions presented by petitioners are not addressed to respondent Smith Barney Inc. ("Smith Barney," formerly Smith Barney, Harris Upham & Co. Inc.).

OTHER PARTIES BELOW

In addition to parties named in the caption, petitioners asserted claims below against Dean Witter Reynolds, Inc. (in the district court) and Robinson Interests, Inc. (in the district court and court of appeals).

DISCLOSURE PURSUANT TO RULE 29.1

Pursuant to Rule 29.1, Respondent Smith Barney Inc. (formerly Smith Barney, Harris Upham & Co. Inc.) states that the following parent, subsidiary or affiliated companies have issued securities to the public: The Travelers Group, Inc.; Smith Barney Holdings, Inc.; and Commercial Credit Co.

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STATEMENT OF THE CASE

Worlds of Wonder ("WOW") was a toy company founded in 1985. During its first two years of existence, WOW developed the nation's top-selling toy for each of those Christmas seasons. In 1985, WOW's animated talking bear, Teddy Ruxpin, headed the "wish list" of millions of children. In 1986, WOW's "Lazer Tag" game was another runaway best-seller.

In early 1987, WOW introduced a greatly expanded product line and extensions to its existing toys, all of which were greeted with enthusiasm by retailers, consumer marketing and industry experts. Based upon the anticipated increased demand for its products, WOW sold $80 million in convertible debentures on June 4, 1987 to enhance its product development and manufacturing capacity. The debenture prospectus, which reflected the intensive "due diligence" investigation conducted by underwriter Smith Barney, emphatically warned of the significant risks faced by this thinly-capitalized two-year old company in a highly volatile industry.

The strongly-worded prospectus warnings proved to be highly effective. The WOW debentures were rated as "junk bonds" by Standard & Poor's and Moody's investment services and paid a premium 50% above the prevailing rate for investment grade securities. As the district court later observed, "[i]t was obvious to any reasonable investor that WOW would be unable to survive any unanticipated shortfall in its revenues, and this risk was well known to the market." *In re Worlds of Wonder Securities Litigation ("WOW")*, 814 F. Supp. 850, 854 (N.D. Cal. 1993).

The prospectus warnings also proved to be prophetic. As investors had been cautioned, WOW was not able to come up with a new hit toy for 1987, and Teddy Ruxpin and Lazer Tag fell out of favor with America's pre-teens. The profound seasonality of the toy business, as had been forewarned, prevented WOW from recovering the costs of its expansion incurred during the first half of 1987 when it did not achieve its projected sales during the second half of that year. Unable to finance new lines of toys, WOW declared bankruptcy in late 1987.

Although securities litigation inevitably accompanied WOW's downfall, it was immediately apparent that WOW's debenture prospectus disclosed precisely the risks and problems that ultimately caused the company's demise. In 1988, the district court initially dismissed petitioners' complaint, without prejudice, and warned that **"it is clear that some of the risks which plaintiffs claim were omitted were in fact disclosed in the prospectus."** *WOW*, 694 F. Supp. 1427, 1434 (N.D. Cal. 1988) (the district court "declining at [this] point in the litigation to sift through the individual allegations and decide, as a matter of law, which risks were actually disclosed"). Finally, after more than 80 depositions and "a tortured five years of proceedings," *WOW*, 35 F.3d 1407, 1412 (9th Cir. 1994) (App. 5),[1] the district court carefully scrutinized the factual record and each of petitioners' allegations.

In a ruling that the court of appeals described as "an exhaustive opinion," *WOW*, 35 F.3d at 1412 (App. 5), the

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[1] "App. ___" references are to the pages of the court of appeals' opinion as they appear in the Appendix submitted with the Petition.

district court granted summary judgment in favor of all respondents as to the textual portions of the debenture prospectus.[2] Following its painstaking review of each challenged prospectus disclosure, the district court concluded:

> "[I]f courts were to allow plaintiffs in securities fraud cases to survive summary judgment in the face of disclosures this detailed and specific, there would be no point for companies to disclose risks at all." *WOW*, 814 F. Supp. at 866.

The district court's decision also held that petitioners had failed to establish scienter, saying there was "insufficient evidence, as a matter of law, for the jury to find intent to deceive on the part of any defendant in connection with WOW's securities offerings." *Id.* at 873. With respect to Smith Barney, the district court further concluded that "as part of Smith Barney's 'due diligence' inquiry, Smith Barney specifically sought and received assurances from Deloitte on the [challenged portions of the WOW financial statements]. Thus, Smith Barney clearly exercised reasonable care, and it did not have any reason to know that there were any errors in the financial statements." *Id.* at 868.

Relying on the same fact-specific arguments that are now before this Court, petitioners twice sought reconsideration from the district court. Because these arguments "present[ed] no new issues of law or fact," and

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[2] Respondent Smith Barney also asserted a "due diligence" defense against liability under Sections 11 and 12(2) of the 1933 Act, and the compelling factual basis for this independent defense has never been contested by petitioners.

there was no showing that the court's order was in error, the district court denied reconsideration. *Id.* at 874. Undeterred, petitioners sought *de novo* review by the Ninth Circuit Court of Appeals, but did not challenge any aspect of Smith Barney's independent "due diligence" defense or the district court's ruling that Smith Barney lacked scienter.

The court of appeals affirmed summary judgment as to the textual portions of the prospectus with its own detailed analysis of the evidence. It methodically reexamined each of the disclosures now challenged by petitioners and concluded that there were no material misstatements or omissions. The court of appeals also made clear that any reference to the "bespeaks caution" doctrine "merely represent[ed] the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance." *WOW*, 35 F.3d at 1414 (App. 10). With respect to Smith Barney's "due diligence" defense, the court held that petitioners had waived appeal of the issue by failing to mention it in their opening brief. *Id.* at 1424 (App. 36).

Petitioners next petitioned the court of appeals for a rehearing and sought *en banc* review by the entire court. No judge on the appellate panel voted to rehear the matter, and no judge on the entire court requested a vote on rehearing *en banc* (App. 51). Still unsatisfied, the petitioners have now repackaged the very same fact-intensive challenges to the decisions below as a Petition for Writ of Certiorari to this Court. Although four "questions" have been presented to the Court, the only issue involving Smith Barney is whether this Court should now second-

guess the careful and thorough evidentiary determinations made by two lower courts.[3]

SUMMARY OF ARGUMENT

Petitioners have presented no question worthy of the Court's attention. No conflict among the courts of appeal is offered, no unsettled question of federal law is advanced. Sup. Ct. Rule 10. Instead, devoting twice as much of their petition to factual contentions as to legal points, petitioners merely belabor yet again the tired claim they have repeated throughout this "tortured" litigation: the lower courts failed properly to apply settled law to petitioners' attempted portrayal of the facts.

Petitioners do not object to the court of appeals' legal analysis of the WOW prospectus disclosures. They concede that the "bespeaks caution" label employed by the court below is "essentially shorthand for the well-established principle that a statement or omission must be considered in context." Petition ("Pet.") at p. 24. Similarly, there is no real disagreement as to the proper scope of the bespeaks caution doctrine. The court of appeals, and the district court before it, expressly premised their decisions on the proposition that cautionary statements ***cannot*** immunize misstatements on a *per se* basis or cure omissions concerning ***existing facts***. *WOW*, 814 F. Supp.

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[3] While the petition focuses primarily upon the issues concerning proof of scienter under Section 10(b) of the 1934 Act as to the auditors, corporate officers and directors, none of these issues affects the summary judgment in favor of Smith Barney.

at 858; *WOW*, 35 F.3d at 1414 (App. 12). Thus, the interpretation that petitioners have urged on this Court ***is not in dispute.***

In reality, this petition simply rehashes petitioners' disagreement with the factual determinations reached by the district court (after five years of litigation) and the court of appeals (after its *de novo* review). Those prior decisions were painstakingly made after the courts "thoroughly reviewed the record", *WOW*, 814 F. Supp. at 873, and an "avalanche of documents presented by plaintiffs." *WOW*, 35 F.3d at 1420 (App. 27). Because the decisions below were properly founded on a compelling evidentiary record, and an unchallenged legal analysis – and because this Court "do[es] not grant *certiorari* to review evidence and discuss specific facts," *United States* v. *Johnson*, 268 U.S. 220, 227 (1925) – this petition should be denied.

Weak as they are, petitioners' proffered reasons for granting review cannot compare with the poverty of their attempt to make Smith Barney a party to that review. In the courts below, petitioners all but ignored Smith Barney, as epitomized by their addressing Smith Barney in just a single paragraph of their 80-page opening brief to the court of appeals. Their appeal took no issue with the district court's rulings that Smith Barney lacked scienter with respect to the 1934 Act claim and established a "due diligence" defense with respect to the 1933 Act claims. As to the latter, the court of appeals specifically held that petitioners had waived appeal of the issue by failing to mention it in their opening brief.

Nowhere in the questions or arguments they present to this Court do petitioners challenge the lower courts' rulings that Smith Barney lacked scienter and established a due diligence defense. For this reason, Smith Barney respectfully submits that review should be denied as to it regardless of the Court's response to the questions presented by petitioners.

REASONS FOR DENYING THE WRIT

1. Petitioners Complain Only Of The Lower Courts' Application Of Settled Law To A Detailed Factual Record And Suggest No Reason That Could Support The Exercise Of This Court's Discretionary Jurisdiction

This Court's exercise of its discretionary jurisdiction to review petitions for writs of certiorari is limited to cases where "there are special and important reasons therefor." Sup. Ct. Rule 10.1. With respect to those portions of the present petition that concern Smith Barney, there plainly are no such reasons. Indeed, these petitioners do not identify ***any legal issue*** requiring resolution by this Court in their request for still another hearing on their claims. It is well-established that "the jurisdiction of the Supreme Court to review cases by way of certiorari was not conferred upon this Court merely to give the defeated party in the Circuit Court of Appeals another hearing." *Magnum Co.* v. *Coty*, 262 U.S. 159, 163 (1923).

Significantly, petitioners do not contend that the court of appeals' legal analysis is in conflict with that of

any state court or other court of appeals. The petitioners concede that " 'the bespeaks caution doctrine' is merely 'new nomenclature rather than a substantive change in the law.' " Pet. at p. 24, quoting *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 364 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). Petitioners ***agree*** that the appellate court's invocation of the "bespeaks caution" shorthand simply stands for the proposition that prospectus disclosures "must be analyzed in context." Pet. at p. 24, quoting *Rubinstein* v. *Collins*, 20 F.3d 160, 168 (5th Cir. 1994).

Instead, petitioners challenge only the purported application of these uncontested legal principles. Petitioners argue that the court below applied the "bespeaks caution" doctrine as a *per se* rule, "under which the mere fact that the prospectus addressed a particular subject automatically excuses any and all misrepresentations or omissions regarding that subject." Pet. at p. 4. Petitioners further contend that the court below "improperly applie[d] the so-called 'bespeaks caution doctrine' to hold that disclosures of potential risks in a securities prospectus rendered the defendants' misrepresentation and omissions of existing fact immaterial under § 11, § 12(2) and § 10(b)." Pet. at p. 3. With respect to both of these contentions, petitioners hopelessly misstate the conclusions of the court below and ignore the express basis for its decision.

Contrary to petitioners' mischaracterization, the court of appeals' decision in *WOW* **rejected** a *per se* application of the "bespeaks caution" doctrine. The court below repeatedly cautioned that it was applying the doctrine "narrowly," *WOW*, 35 F.3d at 1414 (App. 12), that its

approach was "context-specific," *id.* at 1415 (App. 12), and that its "measured application" of the doctrine required an individualized analysis of the particular disclosures and alleged misstatements. *Id.* at 1414 (App. 11). Indeed, the *WOW* court quoted approvingly and extensively the Fifth Circuit's decision in *Rubinstein* v. *Collins*, 20 F.3d at 167 and n.26, which specifically ***disapproved of*** a *per se* approach in favor of a "fact-and-case specific" analysis.[4] *WOW*, 35 F.3d at 1414-15 (App. 10-12).

Although petitioners contend that the *WOW* decision somehow applied the "bespeaks caution" doctrine as a *per se* rule, other courts that have read the opinion suffer from no such confusion. In *Kaplan* v. *Rose*, 49 F.3d 1363, 1373 (9th Cir. 1994), another panel of the Ninth Circuit recently observed that the *WOW* decision was limited to "precise cautionary language [that] directly addresses itself to future projections, estimates or forecasts in a prospectus." The *Kaplan* court acknowledged the logic of "bespeaks caution" as set forth in the *WOW* decision, and concluded that the cautionary language before it ***did not*** relate directly to the statements at issue. *Id.*

Similarly, petitioners wholly misrepresent the decisions below with their claim that the court of appeals applied the "bespeaks caution" doctrine to immunize

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[4] In fact, the *Rubinstein* court's application of a context-based "bespeaks caution" analysis – which was expressly endorsed by the *WOW* panel – came in the context of the Fifth Circuit's ***reversal*** of a summary judgment that had been granted in favor of defendants based on a *per se* rule.

misstatements of *existing* facts. In truth, the court carefully limited its application of the bespeaks caution doctrine to risk disclosure "which directly addresses itself to future projections, estimates or forecasts in a prospectus." *WOW*, 35 F.3d at 1414 (App. 12). In fact, while the petitioners now pretend that the *WOW* decision is inconsistent with the Fifth Circuit's observation in *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981) ("to caution that it is only possible for . . . unfavorable events to happen when they have already occurred is deceit"), the district court in *WOW* specifically relied upon the same passage in ***dismissing*** petitioners' claims. *WOW*, 814 F. Supp. at 858.

In its decision below, the court of appeals thoroughly examined, *de novo*, all of the prospectus disclosures and the known risks ***at the time of the offering***. With respect to each of the arguments again raised by petitioners, the court below demonstrably followed the proper analysis (emphasis added in each quotation): (a) concerning WOW's liquidity, the court below concluded that "plaintiffs presented no evidence that, ***at the time of the offering***, it was foreseeable that $80 million would be insufficient . . . ," 35 F.3d at 1416 (App. 15-16); (b) concerning WOW's internal controls, the court below recognized both that the prospectus disclosed several *existing* problems, and that "the plaintiffs presented no evidence that WOW's internal controls ***at the time of the offering*** were materially deficient," *id.* at 1417 (App. 18); (c) concerning WOW's sales, the court below separately examined each challenged sales practice and found that none of them "posed a foreseeable risk to WOW's interests ***at the time of the Debenture Offering***," *id.* at 1417-18 (App. 19); and (d) concerning WOW's sales prospects, the

court below again found "no admissible evidence to show that WOW's sales had decreased so dramatically, ***at the time of the Debenture Offering,***" *id* at 1419 (App. 24), and concluded that "[plaintiffs'] argument distills to a contention that WOW should have predicted the collapse in sales that occurred in late 1987, long after the Debenture Offering." *Id.* at 1420 (App. 26).

Finally, petitioners contend that each of these determinations by the court of appeals should now be second-guessed. This half-hearted plea is not based upon any suggestion that the court below employed an improper legal standard in its Rule 56 analysis. It is uncontested that the court of appeals conducted a *de novo* review of the district court's grant of summary judgment and concluded that:

> "In doing so, we are mindful that although materiality and scienter are both fact-specific issues which should ordinarily be left to the trier of fact, summary judgment may be granted in appropriate cases." *WOW*, 35 F.3d at 1412 (App. 6), quoting *Hanson* v. *Dataproducts Corp.*, 976 F.2d 497, 500 (9th Cir. 1992).

Instead, petitioners argue the court below failed to indulge inferences that might have prevented summary judgment in this matter.

In reality, this Court has emphasized that when a defendant presents evidence that undermines any element of a claim, plaintiffs must "come forward with specific facts showing there is a genuine issue for trial."

Celotex Corp. v. *Catrett*, 477 U.S. 317, 324 (1986).[5] The Court below combed the evidentiary record (as had the district court) and found no such genuine factual issues. The *WOW* court concluded (as had the district court) that:

> "Plaintiffs have submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. [That is not sufficient]."

35 F.2d at 1420 (App. 28), quoting *WOW*, 814 F. Supp. at 873.

This Court has observed that "summary judgment procedure is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules." *Celotex Corp. v. Catrett*, 477 U.S. at 327. While petitioners are surely disappointed that the courts below actually devoted the time, energy and resources necessary to scrutinize their claims, there is no basis for this Court's reexamination of the lower courts' careful and measured application of Rule 56. *Graver Mfg. Co. v.*

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[5] *See also Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 252-54 (1986) (the non-moving party must show that there are "genuine factual issues that properly can be resolved only by a finder of fact because they may reasonably be resolved in favor of either party"); *Matsushita Elec. Indus. Co.* v. *Zenith Radio*, 475 U.S. 574, 586 (1986) (in order to survive summary judgment plaintiffs "must do more than show that there is some metaphysical doubt").

Linde Co., 336 U.S. 271, 275 (1949) ("[R]ather than a court for correction of errors in fact finding, [the Supreme Court] cannot undertake to review concurrent findings of fact by two courts below in the absence of a very obvious and exceptional show of error.").

2. Petitioners Have Ignored Two Independent Grounds For Affirming The Judgment Below In Favor Of Smith Barney

Petitioners' failure to mention Smith Barney with anything beyond a passing reference in their petition continues a pattern evident throughout the eight-year history of this litigation. In the district court, Smith Barney established its "due diligence" and lack of scienter with 180 pages of declaration testimony from 15 witnesses who participated in the underwriting of WOW's securities offerings. Petitioners did not challenge a single word of that testimony, thereby compelling the district court's conclusion that Smith Barney possessed a due diligence defense to petitioners' 1933 Act claims, *WOW*, 814 F. Supp. at 867-68, and lacked scienter as to petitioners' 1934 Act claim. *Id.* at 873.

In the court of appeals, petitioners did not even argue the scienter issue as to Smith Barney. Nor did they challenge the district court's conclusion that Smith Barney was entitled to judgment on its due diligence defense. As to the latter, the court of appeals specifically ruled that petitioners had waived the issue on appeal by failing to argue it in their opening brief. 35 F.3d at 1423-24 (App. 36).

In this Court as well, petitioners have chosen to ignore Smith Barney. While they urge the Court to review the absence of scienter found by the court of appeals as to the officers, directors and venture capitalists, Pet. at pp. 27-29, they say nothing about the now-final determination that ***Smith Barney*** lacked scienter. They say nothing about the due diligence defense as to ***any*** respondent, thereby conceding the finality of that determination as well.

Because petitioners have abandoned any challenge as to Smith Barney's due diligence and lack of scienter, neither this Court's review nor a reversal on any of the questions presented could resurrect either a 1933 Act or 1934 Act claim against Smith Barney. As to Smith Barney, the judgment below is beyond meaningful review. Accordingly, certiorari as to Smith Barney in particular should be denied for this reason in addition to the poverty of the petition as to all respondents.

CONCLUSION

For the foregoing reasons, the Court should deny the Petition for a Writ of Certiorari to the extent that it seeks review of the summary judgment granted in favor of Smith Barney.

Respectfully submitted,

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August 28, 1995

(6)

No. 95-154

Supreme Court, U.S.
FILED
AUG 28 1995
CLERK

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

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QUESTIONS PRESENTED

There is no question presented for review here other than Petitioners' belief that both the District Court and the Ninth Circuit wrongly applied settled law to a fact-intensive summary judgment motion. Only by seriously mischaracterizing the Ninth Circuit's decision do Petitioners attempt to manufacture anything resembling a legal question.

The Ninth Circuit affirmed summary judgment in favor of an independent auditor regarding alleged violations of Section 10(b) of the Securities Exchange Act of 1934 in connection with the audit of a client's financial statements. The court found that Petitioners failed to present any evidence of the auditor's scienter, and that Petitioners' expert's declaration lacked sufficient probative value to rebut the auditor's evidence showing a lack of scienter. The court explained that the expert's opinion that the auditor "must have been aware" of missstatements in the company's financial statements was conclusory and based on an "impermissible leap of logic" that failed to create a triable issue from which a jury could infer the auditor's knowledge or recklessness. Should this Court review the Ninth Circuit's decision where:

(1) The decision merely reflects the application of settled law, as to which there is no conflict among the circuits, to the particular facts of this case;

(2) The decision raises no important question of federal law since it has no widespread application beyond the claims and parties of this case.

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INTRODUCTION

Four federal judges have now carefully examined the evidence in this case to determine whether Petitioners, plaintiffs herein, came forward with sufficient facts to raise a triable issue as to Deloitte's alleged scienter. All four – both the district court and the Ninth Circuit panel – found that there was no evidence of scienter, and that, in particular, Petitioners' expert testimony failed to raise any triable issue of Deloitte's purported knowledge or recklessness. Accordingly, the Ninth Circuit affirmed summary judgment in favor of defendant and Respondent Deloitte & Touche LLP ("Deloitte"), a national firm of certified public accountants, on Petitioners' claims under Section 10(b) of the Securities Exchange Act of 1934.

Petitioners now try to invoke the authority of this Court by badly misstating the Ninth Circuit's holding. They say the Ninth Circuit held that, if there are differences of opinion between the experts regarding the issue of an auditor's compliance with professional standards, summary judgment must always be entered in favor of the auditor. But the Ninth Circuit held nothing of the kind. Rather, after a painstaking review of the evidence, the Ninth Circuit held that Petitioners had presented no evidence that Deloitte acted with scienter. The Court found that Petitioners' accounting expert did not provide the missing evidence because his allegations were "conclusory" and he made an "impermissible leap in logic" to reach the conclusion that Deloitte acted with scienter. It summed up the expert's declaration as follows: "In sum, [the expert's] declaration consists of self-righteous statements that, because Deloitte did not audit WOW as he

would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient."

Thus, the first part of Petitioners' first "Question" regarding Deloitte – "can the auditor 'conclusively rebut' scienter, and thereby obtain summary judgment, merely by submitting declarations attesting that its accounting and auditing determinations were reasonable" – is not presented here. The Ninth Circuit's decision is based on an *absence* of evidence presented by Petitioners below, not on the mere existence of declarations submitted by Deloitte. Thus, this petition presents no legal issue and nothing that should take up this Court's time.

Nor is the second part of Petitioners' "Question" – do cases involving accountants present an "exception" to the general rule that summary judgment is inappropriate if plaintiffs present evidence from which a trier of fact could reasonably infer scienter – presented here. Nothing in the Ninth Circuit's opinion says or suggests anything about such an "exception." Rather, the court found that there was no evidence in the record from which a trier of fact *could* infer scienter, quoting with approval the district court's ruling that Petitioners' expert was doing nothing more than "drawing his own conclusion *based on a record that conclusively rebuts any inference of scienter.*" The supposed "exception" to which Petitioners refer is thus nothing more than a figment of their imagination, created in an effort to manufacture something resembling a legal issue.

Petitioners' final "Question" – can a court, consistent with Rule 56 and the Seventh Amendment to the United States Constitution, "disregard" or "weigh" the evidence

submitted by the nonmoving party when considering a motion for summary judgment – has no place here either. The Ninth Circuit's decision to grant summary judgment notwithstanding Petitioners' conclusory and illogical expert declaration was entirely consistent with this Court's precedents regarding Rule 56.[1]

Petitioners' real disagreement, therefore, is not with the Ninth Circuit's *articulation* of any legal principle, but with its *application* of settled law to the particular facts of this case, and its conclusion that Petitioners' expert testimony was simply too conclusory and illogical to provide the otherwise missing evidence of Deloitte's scienter. Whether or not that conclusion was correct – as four federal judges have now held – it has no application beyond the claims and parties in this case. Accordingly, the petition should be denied.

STATEMENT OF THE CASE

This action arises out of the June 1987 public offering of $80 million of high yield bonds (the "Offering") by Worlds of Wonder, Inc., a high-tech toy manufacturer ("WOW"). After the Offering, WOW made a series of public disclosures, the market price of the debentures declined, and ultimately the company collapsed. Petitioners are a class of disappointed investors who alleged securities fraud in connection with the Offering against

[1] Petitioners' other questions (numbers (2) and (3)) do not appear to be directed at Deloitte, and therefore are not addressed here.

eleven defendants, including WOW's principal officers and directors, its underwriters, and its independent auditor, Deloitte.[2]

Petitioners asserted a variety of claims against Deloitte, including a claim under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10(b)(5) (collectively, "Section 10(b)"), which is the subject of their petition. Petitioners' Section 10(b) claim is based upon alleged accounting errors in WOW's March 31, 1987 ("fiscal 1987") audited financial statements. The alleged accounting errors primarily involved revenue recognition on sales that were recorded in fiscal 1987, but which Petitioners claimed should have been recorded, if at all, in the fiscal year ending March 31, 1988 ("fiscal 1988").

To sustain a claim under Section 10(b), Petitioners must establish Deloitte's scienter, defined as "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). To prove scienter, Petitioners must prove either knowledge or recklessness,[3] which is defined as conduct

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[2] On August 15, 1994, respondent Deloitte & Touche became a registered limited liability partnership, and is now known as Deloitte & Touche LLP. Pursuant to Supreme Court Rule 29.1, Deloitte states as follows: Deloitte has no parent companies and has no subsidiaries that have issued stock to the public.

[3] The question of whether recklessness, rather than knowing misconduct, is sufficient to trigger liability under Section 10(b)'s statutory language, remains open. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. at 193 n.12 (reserving the question whether "in some circumstances" recklessness is sufficient for

> involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991) (quoting *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977)).

Deloitte moved for summary judgment on the ground that there was, *inter alia*, no evidence of scienter. The district court agreed and granted the motion. After carefully reviewing both Deloitte's and Petitioners' evidence on the issue, the court concluded that Petitioners had failed to come forward with evidence from which a jury could reasonably infer Deloitte's knowledge or recklessness. Thus:

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civil liability under Section 10(b)). There is a strong argument that in light of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1448 (1994), and other authorities, it is not. Indeed, the question is presently before this Court in *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1994), *petition for cert. filed*, 63 USLW 3892 (U.S. June 12, 1995) (No. 94-2027). However, even if the Ninth Circuit erred in applying the recklessness standard here, it was an error in Petitioners' favor, which if corrected, would only provide additional support for the Ninth Circuit's affirmance of the trial court's decision. Petitioners would then have an even greater burden to establish scienter. Therefore, the question of whether the court was correct to apply the recklessness standard is not material to the questions raised by this petition.

> Deloitte has submitted evidence showing that it extensively investigated, carefully addressed, reasonably resolved, and thoroughly documented every transaction where Plaintiffs allege revenue was improperly recognized. Also, Deloitte submits the declarations of its accountants that recognition of the revenue was proper in accordance with Generally Accepted Accounting Principles ("GAAP"). The thoroughness of Deloitte's investigation into the transactions in question certainly meets Deloitte's burden of showing that there is no genuine issue of fact on the issue of scienter.

In re Worlds of Wonder Sec. Litig., 814 F. Supp. 850, 870 (N.D. Cal. 1993) (App. A-47) ("*WOW I*").[4]

In contrast, Petitioners submitted no direct evidence of Deloitte's scienter. Instead, Petitioners sought to establish Deloitte's scienter inferentially through the declaration of their expert, Albert Rossi. Rossi opined that revenues were improperly recognized under Generally Accepted Accounting Principles ("GAAP"), and that "[t]he danger that Deloitte's audit opinion . . . would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it." *Id.* (App. A-47).

The district court found, however, that Petitioners' evidence "did not have enough probative value to rebut Deloitte's evidence showing a lack of scienter." *Id.* at 878 (App. A-67). Citing well-settled principles limiting the

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[4] Petitioners did not include the district court's opinion in the appendix to their petition, as this Court requires. Sup. Ct. Rule 14.1(k)(ii). The opinion is therefore attached hereto as Appendix A.

deference to be given to expert testimony at summary judgment, the district court held that Rossi's declaration was too conclusory to shed any light on Deloitte's mental state at the time of the audit:

> As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. [*In re Apple Computer Sec. Litig.*, 886 F. 2d 1109, 1116 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).] "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any inference of bad faith. *See* [*In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1504 n.30 (N.D. Cal. 1992)].
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> Here, Rossi's conclusory opinion . . . is not based on specific facts that shed light on the mental state of Deloitte's auditors, and from which the jury on their own could infer scienter. Rather, Rossi is drawing his own conclusion based on a record that conclusively rebuts any inference of scienter. [Citation omitted.] As such, Rossi's opinion is more probative of Plaintiffs' desperation to keep Deloitte, a "deep pocket," involved in this lawsuit than it is on the issue of whether Deloitte acted with scienter.

WOW I, 814 F. Supp. at 870-71 (App. A-47-48). The district court reaffirmed its holding in denying Petitioners' motion for reconsideration. *Id.* at 878 (App. A-67).

A unanimous Ninth Circuit affirmed. Noting that Petitioners had presented no direct evidence of Deloitte's

scienter, and had essentially conceded that Deloitte made a thorough investigation into WOW's finances, the court held that Rossi's opinion that Deloitte should have resolved WOW's accounting issues differently was not enough to raise a triable issue of scienter in the face of Deloitte's evidence:

> [T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter. [Citations omitted.] "[Scienter] requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." [Citation omitted.] As a result, Deloitte's evidence indicating that the accounting decisions were reasonable negates the plaintiffs' attempt to establish scienter.
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> In sum, [Rossi's] declaration consists of self-righteous statements that, because Deloitte did not audit WOW as he would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient.

In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426-27 (9th Cir. 1994) (App. 43-44) ("*WOW II*").[5]

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[5] At several points in their petition, Petitioners appear to complain that this is the wrong standard for scienter, claiming it

Quoting much of the lower court's opinion, including its statement of the principles governing the effect of expert opinion at summary judgment, the Ninth Circuit concluded that Rossi's conclusion that Deloitte acted with scienter involved an "impermissible leap in logic" unsupported by the facts, and amounted to nothing more than " 'disagreement with Deloitte's professional judgment [which] does not meet [the recklessness] test.' " *Id.* at 1426 (quoting district court) (App. 42-43). The court noted that simply because Deloitte knew the general terms of the disputed transactions, which Deloitte freely admitted, that did not mean it also knew of any misrepresentation or omission in WOW's financial statements:

"paradoxically" focuses only on recklessness, and establishes a "uniquely lenient rule for auditors" which precludes liability even when the auditor acted knowingly or "deliberately." *See* Petition at 16 & 23 n.15; *see also id.* at 23. They argue that certiorari therefore is warranted because the standard "contravene[s] the express provisions of . . . § 10(b)," is wrong "as a matter of policy," and defeats the "purpose" of the federal securities laws. Petition at 22-23. Petitioners misconstrue the standard of scienter articulated by the court. The court is not focusing on recklessness to the exclusion of actual knowledge. Actual knowledge is not specifically mentioned in the court's articulation of the scienter standard because, as the court itself observed just before it recited the standard, it was undisputed that there was no direct evidence of Deloitte's knowledge or recklessness. *WOW II*, 35 F.3d at 1426 (App. 42). The court therefore confined itself to the showing necessary to establish recklessness, the only remaining avenue by which Petitioners could raise a triable issue of scienter. *See also id.* (quoting with approval Deloitte's statement of the standard of scienter: "whether Deloitte had 'actual knowledge' of a misrepresentation, or whether [its conduct constituted] 'an extreme departure' from reasonable accounting practice[.]").

> Deloitte freely acknowledges that it had "full information" about the terms of the disputed transactions. . . . Deloitte knew many facts because it did a diligent audit. But the issue is not whether Deloitte knew facts about transactions; it is whether Deloitte had "actual knowledge" of a misrepresentation, or whether Deloitte's resolution of the accounting issues presented by those facts was such "an extreme departure" from reasonable accounting practice that it "knew or had to have known" that its conclusions would mislead investors. [Citation omitted.] Rossi's disagreement with Deloitte's professional judgment does not meet that test.[6]

Id. (App. 42-43).

REASONS FOR DENYING THE WRIT

I. SUMMARY OF ARGUMENT

This Court should refuse to grant review of this decision for three reasons:

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[6] In summarizing this aspect of the court's opinion for purposes of their petition, Petitioners incorrectly state that the Ninth Circuit "acknowledged that the auditors had known all of the facts which allegedly made the financial statements misleading" – inappropriately attempting to equate "knowledge of the facts" with scienter. *See* Petition at 15. As quoted above, the court stated only that "Deloitte freely acknowledges that it had 'full information' about the terms of the disputed transactions." *WOW II*, 35 F.3d at 1426 (App. 42). As the court itself points out, nothing in that statement suggests, nor did Deloitte concede, that at the time of the audit, Deloitte *also* knew that WOW's treatment of the disputed transactions in the financial statements was *misleading*.

First, the Ninth Circuit followed settled law, holding that the trial court was not required to defer to the nonmovant's expert testimony at summary judgment when the evidence in support of the moving party is otherwise clear. It properly applied that law to the particular circumstances of this case, and found that the trial court appropriately granted summary judgment in favor of Deloitte notwithstanding Petitioners' attempted showing. Both its decision and its analysis were completely consistent with controlling authority under Rule 56.

Second, stripped of Petitioners' mischaracterizations, nothing in the Ninth Circuit's holding conflicts with a decision from another circuit. It broke no new legal ground, and bodes no dire consequences.

Finally, the decision raises no important federal question requiring this Court's review. Petitioners' expert evidence failed, not because the Ninth Circuit adopted the wrong rule, but because it found that Petitioners' evidence was too conclusory and illogical to raise a triable issue. Even if, *arguendo*, the Ninth Circuit was wrong, that finding has no widespread application to anyone beyond the parties to this case.

II. THE LEGAL ISSUE PETITIONERS RAISE IS WELL-SETTLED

A. The Ninth Circuit Applied Well-Established Law Regarding Expert Testimony At Summary Judgment

Petitioners have based their petition on a gross mischaracterization of the Ninth Circuit's holding in this case.

The Ninth Circuit did not hold that "conflicting expert declarations *require* the entry of summary judgment in the auditor's favor." Petition at 20 (emphasis added). Nor is it true that as a consequence of this decision, "a § 10(b) plaintiff can *never* get to the jury on the *scienter* issue, no matter how strong his evidence of fraudulent intent, knowledge or recklessness, as long as the auditor proffers expert testimony that its accounting determinations were valid." Petition at 3 (emphasis in original); *see also* Petition at 16, 23.

Rather, the court explicitly stated the settled principle that, while expert evidence in support of the nonmovant *generally* precludes summary judgment, the trial court need not defer to such evidence where there is a clear record to the contrary:

> As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. [*In re Apple Computer Sec. Litig.*, 886 F. 2d 1109, 1116 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).] "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any inference of bad faith. *See* [*In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1504 n.30].

WOW II, 35 F.3d at 1425-26 (quoting district court) (App. 41-42).

The court then applied that settled principle to the specific circumstances of *this* case, and found that the

Rossi declaration was simply too conclusory and illogical to create a triable issue. *Id.* at 1426 (App. 42). It was not supported by the facts, involved "an impermissible leap in logic" to reach the conclusion that Deloitte had acted with scienter, and amounted to nothing more than " 'disagreement with Deloitte's professional judgment.' " *Id.* (quoting district court) (App. 42-43). In the absence of any direct evidence of Deloitte's scienter, and in light of Petitioners' concession that Deloitte had thoroughly investigated WOW's finances and of Deloitte's evidence supporting the reasonableness of its accounting decisions, the court, under settled law, concluded there was no reason to send this case to a jury. *Id.* at 1426-27 (App. 41-44).

Although the Rossi declaration was unpersuasive in this instance, nothing in the Ninth Circuit's opinion holds or even implies that summary judgment is *always* warranted in the presence of conflicting expert declarations, as Petitioners contend. To the contrary, the opinion makes clear that, as a general rule, summary judgment is *precluded* when expert testimony that supports the nonmovant is presented. However, the opinion also makes clear that the rule is not absolute, and that the trial court may grant summary judgment in the face of contrary opinion testimony when the evidence in support of the moving party is otherwise clear. *Id.* at 1425-26 (App. 41-42).

That statement of law is indisputably correct. The law has *never* required courts to accept conclusions by expert witnesses at summary judgment which would have little probative value to a jury. The cases are legion. *See Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 113 S. Ct. 2786, 2798 (1993) (where trial court concludes that expert evidence is insufficient to allow a reasonable juror to conclude that the expert's position "more likely than not is true," the court may properly grant summary judgment against the proponent of the evidence); *Matsushita Electric Industrial Co. v. Zenith Radio Corp*, 475 U.S. 574, 594 n.19 (1986) (upholding trial court's grant of summary judgment where expert opinion evidence that defendants had conspired to fix prices had "little probative value in comparison with the economic factors . . . that suggest that such conduct is irrational."); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. at 190 (reversing Seventh Circuit, which relied extensively on the declarations of plaintiffs' experts concerning auditors' accounting errors); *In re Software Toolworks, Inc. Sec. Litig.*, 38 F.3d 1078, 1090 (9th Cir. 1994) (expert evidence that accountant knew that transaction failed to satisfy GAAP requirements lacked any factual basis, and at most, established that accountant was negligent), *amended and superseded on den. of reh.*, 50 F.3d 615 (9th Cir. 1994); *Monroe v. Hughes*, 31 F.3d 772, 775 (9th Cir. 1994) (expert opinion that accounting firm violated professional standards insufficient to preclude summary judgment in favor of accounting firm); *Evans v. Mathis Funeral Home, Inc.*, 996 F.2d 266, 268 (11th Cir. 1993) (court has discretion to exclude expert testimony at

summary judgment if it is based on assumptions unsupported by the record); *Turpin v. Merrell Dow Pharmaceuticals, Inc.*, 959 F.2d 1349, 1350 (6th Cir. 1992) (holding that scientific evidence that provided foundation for expert opinion on causation, viewed in the light most favorable to plaintiffs, was insufficient to allow a jury to find it more probable than not that defendant caused plaintiff's injury), *cert. denied*, 113 S. Ct. 84 (1992); *In re Apple Computer Sec. Litigation*, 886 F.2d 1109, 1116 (9th Cir. 1989) ("where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert' "), *cert. denied*, 496 U.S. 943 (1989); Schwarzer, W., *Summary Judgment Under The Federal Rules: Defining Genuine Issues of Material Fact*, 99 F.R.D. 465, 478-479 ("Differences among experts do not inevitably preclude summary judgment[.]").[7]

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[7] *See also Mathews v. Centex Telemanagement, Inc.* [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,440 at 91,037 (N.D. Cal. 1994) (plaintiffs' expert's opinion that company should have written off certain accounts receivable as uncollectible much earlier than it did, and increased its reserve, constituted "difference of opinion" and not evidence of misstatements or material omissions sufficient to preclude summary judgment); *Provenz v. Miller*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,347 at 90,401 (N.D. Cal. 1994) ("The court is not required to defer to the conclusion and subjective contrary opinions of litigation experts formed with the vision of 20/20 hindsight."); *In re Adobe Systems, Inc. Sec. Litig.*, 787 F. Supp. 912, 919 (N.D. Cal. 1992), *aff'd*, 5 F.3d 535 (9th Cir. 1993) (same); *CL-Alexanders Laing & Cruickshank v. Goldfeld*, 739 F. Supp. 158, 164 (S.D.N.Y. 1990) (granting summary judgment in favor of auditor on issue of scienter and holding that the facts necessary to avoid summary judgment " 'cannot be established by mere speculation or idiosyncratic opinion, even if th[e] opinion [about the facts] is held by one who qualifies as an expert under

Moreover, a trial court's rigorous scrutiny of evidence offered in opposition to summary judgment is particularly appropriate in an accounting case. *See Provenz v. Miller* [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,401. The audit process involves dozens, if not hundreds, of professional judgments, and the court must take care to distinguish between evidence amounting to mere disagreement with matters of professional judgment, on the one hand, and evidence of knowledge or recklessness, on the other. *See, e.g., In re Software Toolworks, Inc. Sec. Litig.*, 38 F.3d at 1090 (expert evidence at best established negligence, not scienter).

As this Court has observed, " . . . 'generally accepted accounting principles' are far from being a canonical set of rules that will insure identical accounting treatment of identical transactions. . . . [Generally accepted accounting principles] tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management." *Thor Power Tool Co. v. Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1979).[8] In light of the flexibility inherent in

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Fed.R.Evid. 702' ") (bracketed text in original) (quoting *In re Agent Orange Prods. Liab. Litig.*, 818 F.2d 187, 193 (2d Cir. 1987), *cert. denied*, 487 U.S. 1234 (1988)); *Estate of Detwiler v. Offenbecher*, 728 F. Supp. 103, 140 (S.D.N.Y. 1989) ("summary judgment is appropriate where the nonmoving party relies solely on an expert opinion that is not based on specific facts . . . or that makes unsupported assumptions or ignores important facts").

[8] *See also In re GlenFed, Inc. Securities Litigation*, 42 F.3d 1541, 1549 (9th Cir. 1994) *(en banc)* (accounting concepts "do not always (or perhaps ever) yield a single correct figure"; therefore, claims under Section 10(b) must, *even at the pleading stage*, set forth facts explaining why alleged accounting inaccuracies are "not merely the difference between two permissible judg-

the accounting standards, any hired expert arguing with the benefit of hindsight could find *some* basis to disagree with a handful of the many judgments made during the course of an audit. If such disagreements were, by themselves, sufficient to preclude summary judgment, then summary judgment would *never* be available to an auditor. This cannot be, and is not, the law.[9]

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ments, but rather the result of a falsehood."); *Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306, 315 (5th Cir. 1988) ("an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement."); Accounting Principles Board (APB) Opinion No. 22, ¶ 5 ("Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic alternatives.").

[9] Moreover, many courts do not admit expert opinion as to a defendant's state of mind in a fraud case. Such opinions are considered legal conclusions, which are the province of the court and the trier of fact, and are therefore inadmissible under Fed. R. Evid. 704. *See, e.g., United States v. Scop*, 846 F.2d 135, 139-140 (2d Cir. 1988) (expert's statements that defendants "manipulated" the market for securities and engaged in a "scheme to defraud" held inadmissible); *Marx & Co. v. Diners' Club, Inc.*, 550 F.2d 505, 510 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977) (reversible error to permit expert on securities law to opine as to the "reasonableness" of defendants' conduct); *see also Adalman v. Baker, Watts & Co.*, 807 F.2d 359, 265-68 (4th Cir. 1986) (expert testimony of the meaning and applicability of federal securities laws to the transactions at issue was inadmissible); *cf. Aguilar v. International Longshoremen's Union Local 10*, 966 F.2d 443, 447 (9th Cir. 1992) (using expert testimony to assist court in determining legal issues is improper); *Torres v. County of Oakland*, 758 F.2d 147, 150 (6th Cir. 1985) (trial court erred in admitting expert opinion that plaintiff had suffered employment discrimination, but error harmless on other grounds);

Accordingly, stripped of Petitioners' mischaracterizations, there was nothing new, extraordinary or improper about the Ninth Circuit's articulation of the rule regarding expert opinion evidence, or its decision to grant summary judgment in Deloitte's favor notwithstanding conclusions in an expert declaration that had no factual support in the record.

B. The Ninth Circuit's Decision Was Consistent With Settled Precedent Regarding Rule 56

Petitioners argue that the court violated Rule 56 and their right to a jury trial under the Seventh Amendment by "weighing and resolving conflicts in the evidence," and "refus[ing] to assign any weight to [Rossi's] opinion." Petition at 29-30; *see id.* at 22. But that is not what the court did. To the contrary, the Ninth Circuit neither weighed the evidence nor ignored the Rossi declaration, and its decision was completely consistent with the standards dictated by this Court's precedents regarding Rule 56.[10]

Owen v. Kerr-McGee Corp., 698 F.2d 236, 240 (5th Cir. 1983) (expert opinion that plaintiff contributorily negligent properly excluded; Rule 704 not intended to allow witness to give legal conclusions). Thus, Rossi's opinion that Deloitte "must have been aware" that the financial statements were misleading was little more than legal advocacy masquerading as expert opinion that the Ninth Circuit was not obliged to accept.

[10] One of the principal purposes of summary judgment "is to isolate and dispose of factually unsupported claims or defenses." *Celotex Corp. v. Catrett*, 477 U.S. 317, 323-24 (1986). Summary judgment therefore is regarded "not as a disfavored procedural shortcut, but rather as an integral part of the Federal

Before affirming summary judgment, the Ninth Circuit carefully reviewed all of the evidence presented by the parties, particularly the declaration of Petitioners' expert. After finding that Petitioners had presented no direct evidence of scienter, the Ninth Circuit devoted a considerable portion of its opinion concerning the Section 10(b) claim against Deloitte to the Rossi declaration, explaining why that expert opinion lacked sufficient probative value to raise a triable issue of scienter. *See WOW II*, 35 F.3d at 1425-27 (App. 41-44). At no time did the court "weigh" the Rossi declaration or any of Petitioners' other "evidence." Rather, it determined that there was "*no* direct evidence that Deloitte acted with scienter," *WOW II*, 35 F.3d at 1426 (emphasis added) (App. 42), and that the Rossi declaration was too conclusory, illogical and unsupported by the record to create a genuine issue of scienter. *Id.* It was the *substance* of Rossi's declaration, therefore, not its relative weight, which the Ninth Circuit found insufficient.

This decision broke no new legal ground. To the contrary, the court's finding, after careful review, that Rossi's declaration failed to establish a genuine issue of material fact was squarely in accord with this Court's interpretation of Rule 56:

Rules as a whole, which are designed 'to secure the just, speedy and inexpensive determination of every action.' " *Id.* at 327 (quoting Fed. R. Civ. P. 1). Accordingly, courts must construe Rule 56 with regard "not only for the rights of persons asserting claims . . . but also for the rights of persons opposing such claims . . . to demonstrate in the manner provided by the Rule, prior to trial, that the claims and defenses have no factual basis." *Id.*

> There is no genuine issue if the evidence presented in the opposing affidavits is of insufficient caliber or quantity to allow a rational finder of fact to find [scienter].

Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 254 (1986).

It is also settled that once the moving party demonstrates, as Deloitte did here, that there is no genuine issue of material fact, the nonmoving party must "make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex*, 477 U.S. at 322. In evaluating any such showing, however, a court is not obliged to accept just *any* evidence in opposition to summary judgment. The "mere existence of *some* factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact." *Anderson*, 477 U.S. at 247-48 (emphasis in original).

Petitioners therefore had to "do more than simply show that there [was] some metaphysical doubt as to the material facts." *Matsushita Electric*, 475 U.S. at 586.[11] They

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[11] Indeed, if the claim is one "that simply makes no economic sense," the party opposing summary judgment "must come forward with more persuasive evidence to support their claim than would otherwise be necessary." *Matsushita*, 475 U.S. at 587. Here, Petitioners presented no evidence suggesting any rational economic motivation Deloitte would have had to commit the fraud alleged in this action. Accordingly, the Ninth Circuit specifically rejected Petitioners' contention that Deloitte's evidence must be viewed with "particular skepticism" because it had earned professional fees for its accounting services:

had to "come forward 'with specific facts showing that there is a genuine issue for trial.' " *Id.* at 587 (quoting Fed. R. Civ. P. 56(e)). They never did. Rossi's declaration was simply too conclusory and illogical to effectively rebut Deloitte's evidence showing a lack of scienter, and therefore summary judgment was properly granted. *See Anderson*, 477 U.S. at 249-50 ("If the evidence is merely colorable, . . . or is not significantly probative, . . . summary judgment may be granted.").

III. THIS CASE DOES NOT MEET THE CRITERIA FOR CERTIORARI UNDER SUPREME COURT RULE 10

A. There Is No Conflict With The Decisions Of Other Courts Of Appeal

Petitioners argue that the Ninth Circuit's rule regarding expert testimony conflicts with what they claim is the "rule" in other circuits: namely, that the auditor can *never* obtain summary judgment in the presence of conflicting expert testimony.

> . . . It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees. The Court therefore declines the [plaintiff]'s invitation to look with a jaundiced eye at each accounting decision made during a complex audit merely because of an accountant's economic motivation in maintaining an ongoing relationship with a client.

WOW II, 35 F.3d at 1427 n.7 (App. 44-45), citing *SEC v. Price Waterhouse*, 797 F. Supp. at 1242 & n. 60.

> [W]here the plaintiff supports his case with the competent, admissible testimony of an expert witness attesting that the auditor violated GAAP and GAAS, that auditor *cannot obtain summary judgment* on the issue of scienter, *even if* he presents testimony from an expert witness of his own defending the validity of his accounting determinations.

Petition at 21 (emphasis added); *see also* Petition at 3, 22.

There is *no* such rule, and thus *no* conflict. None of Petitioners' authorities holds that expert opinion *alone* is always enough to raise a triable issue of scienter. Nor does any require the court to defer to expert conclusions where it finds those conclusions unsupported by any facts. Indeed, Petitioners' cases either do not involve expert opinion concerning scienter, or rely on *other* factual evidence in the record in conjunction with expert opinion. In *Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994), the court relied exclusively on the "direct testimony" of defendant's sales executives to conclude a triable issue of scienter had been raised. The only mention of Petitioners' expert testimony concerned the issue of whether the company's statements were misleading, not the issue of the company's scienter. *Id.* at 478. Even then, the court focused extensively on additional evidence, including the testimony of three former company sales executives and "other evidence that the plaintiffs presented at trial." *Id.*

Similarly, *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir. 1982), *cert. denied*, 459 U.S. 838 (1982), did not involve any expert testimony concerning scienter. The court relied on evidence that a company officer, who had

actual knowledge of the fraud, was also the accountant's former employee for three of the four years at issue, and on other evidence that the accountant had notice that inventories and sales had been overstated in the company's financial statements over a four year period. *Id.* at 576. The only expert testimony mentioned in the opinion concerned the measure of damages, which is not at issue here. *Id.* at 576-77.

In *Fine v. American Solar King Corp.*, 919 F.2d 290 (5th Cir. 1990), *cert. dismissed*, 112 S.Ct. 576 (1991), the court relied on a variety of evidence, in addition to expert testimony, to find that a triable issue had been raised, including a memorandum in the auditors' workpapers demonstrating that the auditors believed the company's reserves were inadequate, an "admission" that the auditors did not believe the company when it said its reserves were adequate, and evidence of the auditors' "improper motive" to assist the company in misleading the public. *Id.* at 296-98. Unlike Mr. Rossi here, plaintiffs' expert did not presume to opine on the accountant's alleged scienter.

In *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), the court relied primarily on the accountants' notes and memoranda, their admissions, contradictions in their respective versions of events and with the statements of other witnesses, and the government's evidence of motive, to find that a jury could reasonably find that the accountants had *known* for years that the client company's president had looted the company of millions through "loans" to an affiliate over which he also presided. *Id.* at 807-810. Indeed, the court did not appear to put much stock in the government's

accounting experts, noting only that they "took a contrary view" to defendants' experts, and "hardly compared with defendants' [eight expert] witnesses in aggregate auditing experience or professional eminence." *Id.* at 805.

In *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314 (S.D.N.Y. 1982), the court noted that the jury had ample evidence, in addition to expert testimony, from which to conclude that the accountant knew that the transaction at issue was a sham, that it had discovered the client's fraud in the course of its audit, and that it knowingly agreed to issue an unqualified and misleading audit opinion. *See id.* at 1353; *see generally id.* at 1334-43 (summarizing evidence from accountant's workpapers, admissions and testimony presented to the jury). Moreover, the expert report presented to the jury in that case, unlike Rossi's declaration here, did not opine on the accountant's state of mind. Instead, it took care *not* to presume knowledge or intent on the part of the accountant or any involvement in fraud, and impressed the court with its fair and balanced application of the relevant accounting guidelines to the accountant's alleged conduct. *Id.* at 1372-73.

In sum, there is nothing in Petitioners' authorities to suggest a conflict among the circuits. Their cases do not suggest a different rule, merely different facts. To the extent they involved expert testimony at all, Petitioners' cases were decided on the basis of the factual record, and do not suggest that the courts must blindly accept any expert opinion offered, no matter how inadequate, or that they *must* automatically deny summary judgment simply

because the opposing party has found an "expert" willing to file a declaration on its behalf.[12]

Indeed, the "rule" Petitioners tout as the correct one would be just as extreme and unjust as the purported "rule" they profess to oppose. Under Petitioners' "rule," Petitioners would effectively turn their expert into a *de facto* judge for purposes of summary judgment. By getting Mr. Rossi or someone like him to question the accounting judgments made by the auditor, and to

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[12] Petitioners also appear to suggest that the Ninth Circuit's holding conflicts with another alleged "rule" in other circuits: namely, that a *prima facie* case against an auditor under Section 10(b) is established by showing that the auditor acted "either recklessly or with *knowledge of the facts* which render [the financial statements] misleading." *See* Petition at 21 (emphasis added). Again, there is no such rule. Scienter is not established by mere knowledge of the *"facts"* which render a statement misleading, but by knowledge of the alleged *misrepresentation or omission*. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (Section 10(b) proscribes use of any manipulative or deceptive device or contrivance with scienter); *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197 (Section 10(b) proscribes "knowing and intentional misconduct"); *In re Donald J. Trump Sec. Litig.*, 7 F.3d 357, 368 n.10 (3d Cir. 1993) (plaintiffs must plead that defendants made material misrepresentations or omissions with knowledge or recklessness), *cert. denied*, 114 S. Ct. 1219 (1994). The distinction is critical. An auditor, for example, ordinarily becomes aware of innumerable facts concerning its client's transactions as a result of the procedures it performs in the course of an audit. However, that simply means that the auditor is doing its job, not that the auditor believes that the client's treatment of the transactions in the financial statements is incorrect or misleading.

Petitioners' authorities are not to the contrary. None extends liability to defendants who merely know of the facts but

paraphrase the case law by stating that the questioned judgments were an "extreme departure" from ordinary standards of care, Petitioners would be able to routinely impose an insurmountable obstacle to summary judgment for auditors.

The better rule, of course, is not the fictitious "rule" that Petitioners have fabricated for purposes of their petition, but the *actual* rule articulated by the Ninth Circuit here, and echoed in numerous other circuits, allowing the trial court to grant summary judgment notwithstanding the nonmovant's conclusory expert testimony where the record is clear. Future cases will then be decided, like this one, on the basis of the record, and neither plaintiffs nor

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not the wrongdoing. *See Fine v. American Solar King Corp.*, 919 F.2d at 297-298 ("The party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information. . . . [K]nowledge of an omitted fact, in itself, does not constitute such recklessness unless the party also knows that its failure to disclose the fact could mislead buyers."); *Sirota v. Solitron Devices, Inc.*, 673 F.2d at 573 (scienter established by either "actual knowledge of the misrepresentations or a reckless disregard for the representations' truth or falsity"); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 34 (2d Cir. 1976) (imposing liability on accountant where audit was "materially and knowingly misleading"); *Endo v. Albertine*, 863 F. Supp. 708, 725 n.30 (N.D. Ill. 1994) (evidence showed that defendants acted with intent to defraud when issuing prospectus containing alleged misrepresentations and material omissions); *cf. Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. at 1352 ("Scienter may be shown by [accounting firm's] actual intent to deceive or defraud, knowledge of the falsity of its representation or recklessness."). *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), is inapposite. It is not a Section 10(b) case, and does not even mention scienter.

defendants will be able to guarantee the results of motions for summary judgment merely by putting boilerplate magic words into expert declarations.

B. There Is No Important Federal Question To Be Settled By This Court

This case turns on its own particular facts and is of consequence only to the parties involved. Accordingly, it does not raise an important question of federal law warranting this Court's review.

Petitioners' evidence failed, not because the Ninth Circuit adopted the wrong rule, but because of the insufficiency of their evidence. Petitioners' real complaint then is not with the Ninth Circuit's *articulation* of the law, which was correct, but with its *application* of the law to the facts in this case. The application of settled law to facts, however, does not provide a basis for certiorari, even if the court below applied the law incorrectly. Indeed, the court's decision here to affirm the order granting summary judgment, under the correct rule of law and on the basis of the unique facts before it, will have no substantive impact on the public beyond the immediate parties to this litigation. Thus, this case has no widespread application, and raises no question requiring this Court's review.

CONCLUSION

There is no reason for this Court to review this case, which presents neither a conflict in decisions nor any important federal question. The petition should be denied.

Respectfully submitted,

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August 24, 1995.

APPENDIX A

In re WORLDS OF WONDER SECURITIES LITIGATION.

This Document Relates to: All Actions.

No. C 87-5491 SC.

United States District Court,
N.D. California.

Jan. 20, 1993.

Order Denying Plaintiffs Motion to Reconsider March 8, 1993.

ORDER RE SUMMARY JUDGMENT

CONTI, District Judge.

I. INTRODUCTION

Plaintiffs are a class of purchasers of stock and debentures issued by Worlds of Wonder, Inc. ("WOW"). Plaintiffs have sued several officers of WOW, two members of WOW's board of directors, WOW's independent auditor, the underwriters of WOW's securities offerings, and several major shareholders of WOW stock. Plaintiffs allege federal claims under Section 11 and Section 12(2) of the Securities Act of 1933, and also Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder. In addition, Plaintiffs allege state law claims of fraud and negligent misrepresentation.

Each defendant now moves for summary judgment. The court addresses these motions together in this Order.

II. BACKGROUND

This case arises out of the demise of Worlds of Wonder, Inc. ("WOW"), a high-technology toy company which sold its products to major toy retailers, mass merchants, and department stores. Within a year of its incorporation, WOW reached the peak of success for the toy industry when its first product, a talking teddy bear, became the nation's best selling toy. Two years later, however, WOW's sales had declined dramatically, and WOW was faced with a serious liquidity crisis. WOW filed for bankruptcy protection within three years of its founding.

WOW was formed in 1985 around a single line of toy products, the World of Teddy Ruxpin, which featured an animated talking teddy bear. Teddy Ruxpin was among the best selling toys in the nation for the Christmas season of 1985. WOW ended its first fiscal year on March 31, 1986 with more than $93 million in net sales.

On June 20, 1986, WOW conducted an initial public offering of common stock (the "IPO"). The IPO was underwritten by a syndicate of investment banks and co-managed by Smith Barney, Harris Upham & Co. ("Smith Barney") and Dean Witter Reynolds, Inc. ("Dean Witter").

The offering materials for the IPO included a prospectus dated June 20, 1986 (the "IPO Prospectus"). The IPO Prospectus contained an extensive discussion of the risks WOW posed to investors,[1] including the fact that WOW's success was entirely based on a single product.

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[1] These risk disclosures are set forth in greater detail at *infra* part IV.B.1.

The IPO Prospectus further cautioned investors that, given the competitive nature of the toy industry, WOW could not ensure that it could repeat its initial success. Also, the IPO Prospectus revealed that WOW's working capital, even considering the proceeds from the IPO, was not necessarily sufficient to last through the end of fiscal 1987 (March, 1987). Nevertheless, the investment community was enthusiastic about WOW. On the day of the IPO, the offering price of $18 per share was driven up to $29 by the close of the day.

Following the IPO, WOW continued to grow rapidly. WOW's second major toy was Lazer Tag, a game involving toy weapons that used infrared technology. Lazer Tag, like Teddy Ruxpin, was wildly successful when it first hit the market. It was the best selling toy for the 1986 Christmas season. Also, Teddy Ruxpin maintained its popularity for the most part during 1986. In Lazer Tag and Teddy Ruxpin, WOW had two of the ten best selling toys for the 1986 Christmas season. At the beginning of 1987, WOW was the toast of the toy industry, having recorded net sales of over $327 million for the previous fiscal year.

WOW's officers hoped to continue WOW's tremendous growth by introducing new lines of animated toys based on the Muppets characters, and by introducing lines of accessories intended to extend the life span of the demand for Teddy Ruxpin and Lazer Tag. To raise the necessary capital, on June 4, 1987 WOW conducted an offering of $92 million worth of convertible debentures

(the "Debentures").[2] The Debenture offering was underwritten solely by Smith Barney.

The offering materials included a prospectus dated June 4, 1987 (the "Debenture Prospectus"). The Debenture Prospectus, much as the IPO Prospectus, contained an extensive discussion of the specific risks inherent in investing in WOW.[3] The Debenture Prospectus revealed facts showing that WOW's cash position was precarious at best. It was obvious to any reasonable investor that WOW would be unable to survive any unanticipated shortfall in its revenues, and this risk was well known to the market. Indeed, the two major rating agencies for securities, Moody's and Standard & Poors, rated the Debentures as below investment grade – that is, junk bonds. Although Smith Barney had initially indicated that it expected the interest rate WOW would bear on the Debentures to be 5.5-6%, the market ultimately demanded a 9% rate.

WOW's fortunes took a drastic turn for the worst shortly after the Debenture Offering. Financial results for the quarter ended June 30, 1987 were below the company's internal projections, even though the company had already predicted a substantial loss for the quarter. WOW's management hoped that the decline in sales was due to the normal seasonality of the toy business, where most sales occur during the Christmas season.

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[2] Debentures are unsecured debt, as opposed to bonds, which are secured by the assets of the issuing company.

[3] These risk disclosures are set forth in greater detail at *infra* part IV.C.1.

The big 1987 Christmas season that WOW had wished for, though, never occurred. WOW's officers blame the stock market crash on October 19, 1987. According to WOW's management, this made retailers cautious about ordering additional products. For whatever reasons, the entire toy industry experienced a severe downturn in late 1987. WOW was especially hurt because its only major products, Lazer Tag and Teddy Ruxpin, were high priced items that were particularly dependent on the Christmas season for sales. A substantial price reduction in WOW's major products in late October 1987, combined with a stepped-up advertising campaign, failed to spur sales to expected levels.

In December, 1987, WOW defaulted on the first interest payment on the Debentures. Faced with a severe liquidity crisis, WOW was unable to make it through the Christmas season as a going concern. WOW filed for bankruptcy on December 21, 1987.

The plaintiffs in this action are a class of purchasers of WOW common stock and Debentures ("Plaintiffs").[4] Plaintiffs assert that they were defrauded, or at least misled, regarding the risky nature of their investment. Plaintiffs allege that several of the various defendants' actions in connection with WOW's securities offerings misled investors, and unduly inflated the market price of WOW's securities. Most notably, Plaintiffs claim that the

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[4] This court certified the class pursuant to Federal Rule of Civil Procedure 23(b)(3) in an Order dated March 23, 1990. The class consists of individuals who purchased WOW common stock or Debentures during the period June 20, 1986 through November 9, 1987.

IPO Prospectus and the Debenture Prospectus contained misleading statements and omitted material information. They also claim that several of the defendants traded WOW stock based on inside information.

Plaintiffs' Third Amended Complaint (the "Complaint") names as defendants several officers of WOW: Angelo M. Pezzani, former President and Chief Operating Officer; Donald D. Kingsboro, WOW's former Chief Executive; and Richard B. Stein, former Executive Vice President and Chief Financial Officer (collectively the "Officer Defendants"). The Complaint also names two directors of WOW as defendants: John B. Howenstein and Barry H. Margolis. Plaintiffs also allege claims against WOW's independent auditor, the public accounting firm of Deloitte Haskins & Sells, now known as Deloitte & Touche ("Deloitte"), and the underwriters of WOW's securities offerings, Smith Barney and Dean Witter (the "Underwriter Defendants"). The Complaint also alleges claims against certain large shareholders of WOW: Josephine E. Abercrombie, an individual; World of Wonder Shares Partnership ("WOW Shares Partnership"); and Robinson Interests, Inc. ("Robinson").

Plaintiffs' Complaint sets forth claims for relief alleging numerous violations of the federal securities laws. Plaintiffs' First Claim for Relief alleges violations of Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j (b), and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder, 17 C.F.R. § 240.10(b)(5). Plaintiffs' Fifth and Sixth Claims for Relief, respectively, allege violations of Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (a), in connection with the IPO

Prospectus and the Debenture Prospectus. Plaintiffs' Seventh and Eighth Claims for Relief allege violations of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), in connection with the IPO Prospectus and the Debenture Prospectus, respectively. Plaintiffs' Second and Ninth Claims for Relief state theories of joint and several liability for the alleged substantive violations of the securities laws.

In addition, Plaintiffs' Third and Fourth Claims for Relief allege state law claims of fraud and negligent misrepresentation, respectively.

The case is currently before the court on the various defendants' motions for summary judgment. The court addresses these motions together in this Order.

III. SUMMARY JUDGMENT STANDARD

Summary judgment is proper if, after viewing the evidence in the light most favorable to the non-moving party, there is no genuine issue of material fact and the moving party is entitled to prevail as a matter of law. Fed.R.Civ.P. 56(c); *Hutchinson v. United States*, 838 F.2d 390, 392 (9th Cir.1988). The party moving for summary judgment has the burden of proving the absence of any genuine issue of material fact. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256, 106 S.Ct. 2505, 2514, 91 L.Ed.2d 202 (1986).

If, however, the moving party demonstrates the absence of any genuine issue of material fact, the burden shifts to the non-moving party to produce evidence sufficient to support a jury verdict in his favor. *Id.* at 255, 106

S.Ct. at 2514. To meet this burden, the non-moving party must go beyond the pleadings and show "by her own affidavits, or by the depositions, answers to interrogatories, or admissions on file" that a genuine issue of material fact exists. *Celotex Corp. v. Catrett*, 477 U.S. 317, 324, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986).

IV. PLAINTIFFS' SECTION 11 CLAIMS

Section 11 of the Securities Act of 1933 creates a private remedy for any purchaser of a security if any part of the prospectus "contained an untrue statement of a material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading." 15 U.S.C. § 77k (a). A Section 11 claim can be asserted against every person who signed the prospectus, the issuer's officers and board of directors, the underwriters of the securities offering, and any expert whose profession gives authority to that part of the registration statement prepared by him. *Id.*

Plaintiffs' Fifth and Sixth Claims for Relief allege violations of Section 11 in connection with the IPO Prospectus and the Debenture Prospectus, respectively. Plaintiffs assert these claims against the Officer Defendants, the Underwriter Defendants, directors Howenstein and Margolis, and Deloitte.

A. *The Bespeaks Caution Doctrine and the Duty to Disclose Information in a Prospectus*

1. The "Bespeaks Caution" Doctrine

The Officer Defendants urge this court to adopt the "bespeaks caution" approach to securities fraud claims. The bespeaks caution doctrine holds that when a prospectus contains substantial disclosure of specific risks, statements that express management's optimism about future performance, despite those particular risks, are not misleading as a matter of law. Though this doctrine has not yet been adopted expressly by the Ninth Circuit, the trend in the recent cases heavily favors adopting this approach. In addition, the bespeaks caution doctrine would be dispositive not only of the claims against the Officer Defendants, but also of many of the claims against the other defendants. Thus, a discussion of the bespeaks caution doctrine and its application is necessary.

(a.) Origins of the Bespeaks Caution Doctrine

The bespeaks caution doctrine originated from language in *Polin v. Conductron Corp.*, 552 F.2d 797 (8th Cir.1977), *cert. denied*, 434 U.S. 857, 98 S.Ct. 178, 54 L.Ed.2d 129 (1977). In that case, the plaintiff, a shareholder in Conductron, alleged fraud by Conductron in its annual report. The report stated that Conductron's "results were 'expected' to show improvement, and the Company saw a 'possibility' of a break-even soon." *Id.* at 806 n. 28. The Eighth Circuit Court of Appeals held that "terms thus employed bespeak caution in outlook and fall

far short of the assurances required for a finding of falsity and fraud." *Id.*

The Second Circuit established the bespeaks caution doctrine more firmly in *Luce v. Edelstein*, 802 F.2d 49 (2d Cir.1986). In that case, the plaintiffs, a class of purchasers of shares in a limited partnership, claimed that the Offering Memorandum made certain false and misleading statements about the potential cash and tax benefits of the partnership. The court found that "the Offering Memorandum made it quite clear that its projections of potential cash and tax benefits were 'necessarily speculative in nature' and that 'no assurance [could] be given that these projections [would] be realized.' " *Id.* at 56. The Offering Memorandum further warned that " '[a]ctual results may vary from the predictions and these variations may be material.' " *Id.* The court held that the plaintiffs had failed to state a claim based on these statements, stating "[w]e are not inclined to impose liability on the basis of statements that 'bespeak caution.' " *Id.* The court relied on *Polin* for this proposition.

Since the *Luce* decision, the First, Sixth, and Eighth Circuit Courts of Appeals have adopted the bespeaks caution doctrine. In the First Circuit case of *Romani v. Shearson Lehman Hutton*, the plaintiffs claimed that the defendants fraudulently induced them to invest in a horse breeding farm. 929 F.2d 875 (1st Cir.1991). The plaintiffs, a class of similarly situated investors, alleged "misrepresentations and omissions in the offering materials that falsely inflated the partnership's financial potential." *Id.* at 876. The court found, however, that "the offering materials are replete with statements, some highlighted, emphasizing the high risks associated with [the

partnership] and that '[t]here can be no assurance that the investment objectives of the Partnership will be obtained.' " *Id.* at 879. The court held that "[d]ocuments such as this, which 'clearly bespeak caution,' are not the stuff of which securities fraud claims are made." *Id.* (citing *Luce,* 802 F.2d at 56).

In *Sinay v. Lamson & Sessions Co.,* 948 F.2d 1037 (6th Cir.1991), the Sixth Circuit addressed a similar claim by a plaintiff class of shareholders. The plaintiffs alleged that certain projections of economic performance by the company's management artificially inflated the price of plaintiffs' shares. *Id.* at 1039. The court found, however, that these projections were "also accompanied by cautionary language." *Id.* at 1040. The court affirmed the district court's dismissal of the case, holding that "economic projections are not actionable if they bespeak caution." *Id.*

The Eighth Circuit reinforced its position on the bespeaks caution doctrine in *Moorhead v. Merrill Lynch,* 949 F.2d 243 (8th Cir.1991). In *Moorhead,* the plaintiffs were purchasers of bonds used to finance a residential retirement center. The retirement center later filed for bankruptcy under Chapter 11, and under the reorganization plan the bondholders only received 60 cents per dollar owed. *Id.* at 244-45. The plaintiffs alleged a claim for securities fraud against Merrill Lynch based upon a feasibility study, prepared by Merrill Lynch and included with the offering memorandum, that was generally favorable on the future economic viability of the retirement center. *Id.* The district court had found that "the feasibility study contained a number of risk statements, detailed cautionary language and disclosures about the underlying economic assumptions, any of which could

have affected the retirement center's ability to pay back the bonds." *Id.* at 245. The court of appeals affirmed the district court's entry of summary judgment for the defendants. *Id.* Though the court did not use the phrase "bespeaks caution," it held that "plaintiffs could not base a federal securities law claim on any misrepresentation or omission in the feasibility study which was addressed by the repeated, specific warnings of significant risk factors and the disclosure of underlying factual assumptions also contained therein." *Id.*

The Ninth Circuit has not yet explicitly adopted the bespeaks caution doctrine. However, the bespeaks caution doctrine is consistent with the Ninth Circuits' approach to securities fraud claims. In *In re Convergent Technologies Securities Litig.*, the plaintiffs, a class of purchasers of stock, alleged that defendants misled investors by concealing information on the company's cost and production problems with one of its product lines. 948 F.2d 507, 515 (9th Cir.1991). The court found, however, that the company's "[p]rospectus virtually overflows with Convergent's repeated emphasis of significant risk factors." *Id.* The prospectus included the following disclosures:

> There can be no assurance that the company will successfully complete the development of its new products or that it will be successful in manufacturing . . . or marketing the products in the face of intense competition;
>
> . . . .
>
> While the Company believes that the technical risks in the development of [the product line] are well controlled, the product cost objectives

> are very aggressive and there is no assurance they can be achieved.

Id. In affirming the district court's entry of summary judgment for the defendants, the court stated that "[n]o investor, in the face of these substantive disclosures, could reasonably conclude that Convergent had surmounted all obstacles in [the product's] path." *Id.* at 516. The court held that the prospectus was not misleading on these issues as a matter of law. *Id.* Thus, this case is consistent with the bespeaks caution approach.[5]

(b.) Application of the Bespeaks Caution Doctrine

The parties disagree, predictably, on the application of the bespeaks caution doctrine to the facts of this case.

The Officer Defendants argue that if the court finds substantial risk disclosure in the IPO Prospectus and the Debenture Prospectus, then the defendants are completely immunized from liability under Section 11. This would be an overextension of the doctrine. Such an overbroad application of the doctrine would "encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language." *Trump Casino,* 793 F.Supp. at 554. To prevent this from occurring, "the bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future

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[5] One court even has read *Convergent Technologies* as adopting the bespeaks caution doctrine as the law in the Ninth Circuit. *See In re Donald Trump Casino Securities Litig.,* 793 F.Supp. 543, 551-52 (D.N.J.1992).

projections, estimates or forecasts in a prospectus." *Id.* By contrast, blanket warnings that securities "involve a high degree of risk" have been held insufficient to ward against a federal securities fraud claim. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir.1981), *aff'd in relevant part and rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).

In addition, the bespeaks caution doctrine does not apply to immunize false statements if the defendants knew the statements were false when made. "To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." *Huddleston*, 640 F.2d at 536.

Plaintiffs, for their part, argue that the bespeaks caution doctrine is no substitute for a fact-specific inquiry into each statement they allege to be misleading. Plaintiffs seem to be arguing that each statement they present to the court must be analyzed, with the benefit of hindsight, to determine whether it was misleading at the time it was made. According to Plaintiffs, the "bespeaks caution" cases discussed above do not obviate the need for this type of inquiry.

Plaintiffs' reading of these cases misses the whole point of the bespeaks caution doctrine. The doctrine holds that economic projections, estimates of future performance, and similar optimistic statements[6] in a prospectus are not actionable when precise cautionary

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[6] "Professional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives, who have a personal stake in the future success of the

language elsewhere in the document adequately discloses the risks involved. It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based. *See Trump Casino,* 793 F.Supp. at 553-54. This aspect of the bespeaks caution doctrine represents an evolution in the judicial analysis of whether a particular statement was misleading.

Accordingly, this court adopts the following formulation of the bespeaks caution doctrine. Estimates or forecasts of future performance in a prospectus are not actionable if the prospectus contains conspicuous language that bespeaks caution as to actual results. Furthermore, the cautionary language must specifically disclose the nature and extent of the risks involved.

In the context of a summary judgment motion, this approach answers in a dispositive way a claim that a particular statement is misleading. The doctrine holds that where a prospectus contains adequate cautionary language disclosing specific risks, no reasonable inference can be drawn that a statement regarding those risks was misleading. This is the analysis this court will apply to Plaintiffs' allegations that particular statements in the IPO Prospectus or the Debenture Prospectus were misleading.

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company." *In re Verifone Securities Litig.*, 784 F.Supp. 1471, 1481 (N.D.Cal.1992) (citations omitted).

2. *The Duty to Disclose Information in a Prospectus*

Plaintiffs also base their Section 11 claims on the defendants' alleged failure to disclose certain risks in the prospectuses. If the documents are completely silent on a matter, the "bespeaks caution" doctrine is inapplicable. One cannot simultaneously bespeak caution on a subject and not address it.

"The securities laws do not require an issuer of stock to disclose every bit of information that has some bearing on the issuer's future earnings." *In re Verifone Securities Litig.*, 784 F.Supp. 1471, 1480 (N.D.Cal.1992). In a fraud on the market case, "[s]ilence, absent a duty to disclose, is not misleading." *Basic, Inc. v. Levison*, 485 U.S. 224, 239 n. 17, 108 S.Ct. 978, 987 n. 17, 99 L.Ed.2d 194 (1988). For Plaintiffs to prevail on a claim that the prospectuses omitted information necessary to prevent a fraud on the market, they must show, "as a threshold matter, that the information was of a kind which the defendants had a legally cognizable duty to disclose." *Id.*

The Supreme Court has set forth the standard for courts to apply in determining whether nondisclosure violates the securities laws. In *Basic, Inc. v. Levison*, the Court held that for nondisclosure to be actionable "there must be a *substantial* likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly* altered the 'total mix' of information made available." 485 U.S. at 231-32, 108 S.Ct.

at 983 (emphasis added).[7] The Court "was careful not to set too low a standard" for disclosure. *Id.* at 231, 108 S.Ct. at 983. The Court expressed concern that too low a standard would "lead management 'simply to bury the shareholders in an avalanche of trivial information – a result hardly conducive to informed decisionmaking.' " *Id.* (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976)).

Thus, in evaluating Plaintiffs' allegations that the prospectuses were misleading for failing to disclose certain risks, the court will inquire whether a hypothetical reasonable investor would have felt the information necessary in deciding whether to invest in WOW.

Having set forth the analytical framework it will apply to this case, the court now turns to Plaintiffs' factual allegations based on the IPO Prospectus and the Debenture Prospectus. As noted above, the allegedly misleading statements or omissions offered by Plaintiffs cannot be judged standing alone. The statements that Plaintiffs claim are misleading must be evaluated in light of the risk factor disclosure set forth elsewhere in the document. Furthermore, the "bespeaks caution" doctrine precludes any inference that a statement which directly relates to any adequately disclosed risk factor is misleading. As to omissions alleged by Plaintiffs, the inquiry for this court is whether the particular omissions were of facts material to WOW's financial well-being at the time

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[7] The Court in *Basic, Inc.* was faced with only a Rule 10b-5 claim, but the lower courts have applied its standard for disclosure in Section 11 cases as well. *See, e.g., In re Verifone*, 784 F.Supp. at 1480.

of the prospectus, so as to obligate WOW to disclose them in the prospectus.

B. *The IPO Prospectus*

1. Risk Disclosure

The IPO Prospectus contains a section titled "Risk Factors." This section consists of three single-spaced pages disclosing WOW's specific business risks, including the following cautionary language:

> **Dependence on Single Product Line; New Product Introductions.** To date, the Company has marketed from a single product line, the World of Teddy Ruxpin. The product life cycle of a toy line is relatively short. Successful new products and new product lines may therefore be crucial to the success of the Company's business. . . . The Company has only limited experience in product introductions, and product line expansion will place great demands on management and other Company resources. If the Teddy Ruxpin product line loses market acceptance, or if new product introductions are unsuccessful, the Company's business would be affected adversely.
>
> . . . .
>
> **Competition.** The toy industry is highly competitive. . . . The relatively low barriers to entry into the toy industry also permit new competitors to easily enter the industry. The Company believes it has enjoyed limited competition to its Teddy Ruxpin product line. Due to the success of Teddy Ruxpin, however, the Company anticipates other companies will introduce talking toy

products that will compete with Teddy Ruxpin and other new products announced by the Company. Such entrants might force price reductions or cause the Company to lose market share, which events may adversely affect the Company.

. . . .

Seasonality of Quarterly Results; Loss for the First Quarter of Fiscal 1987. Sales of toys are highly seasonal, with a majority of retail sales taking place during the Christmas season. Although indications of interest are provided by retailers early in the year, orders are generally cancellable without penalty. The seasonality of sales may cause operating results to vary significantly from quarter to quarter. The company anticipates that net sales for the quarter ending June 30, 1986 will be less than those for the prior quarter and, as a result, the Company expects to report a loss for the quarter. . . . There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in demand.

Capital Requirements. The Company's cash flow from operations, existing bank lines of credit and the proceeds of this offering may not be sufficient to provide the working capital required beyond the end of fiscal 1987. Thereafter, the Company may have to obtain additional working capital from expanded bank borrowings or through additional debt or equity financings. If the Company is unable to obtain adequate working capital from these sources on

> acceptable terms, its operations would be adversely affected. A significant portion of the Company's working capital is composed of accounts receivable. The Company believes the toy industry is characterized by accounts receivable on extended terms, especially in the summer months, and as a result a material portion of the Company's accounts receivable are aged longer than 90 days. The Company's liquidity may be adversely affected by excessive aging of its accounts receivable.

Significantly, the "Risk Factors" section of the IPO Prospectus is not buried beneath other, more optimistic language. On the contrary, it appears as the first major subsection of the document, directly after the Prospectus summary. Moreover, the front page of the IPO Prospectus contains the statement, in boldface type, that "Prospective investors should carefully consider the factors set forth under 'Risk Factors.' "

2. *Plaintiffs' Allegations and Evidence*

In their opposition to defendants' motions, Plaintiffs raise a number of arguments to support their claim that certain statements in, or omissions from, the IPO Prospectus were misleading. The court addresses each of these arguments below.[8]

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[8] The court addresses only those contentions raised by Plaintiffs in their opposition papers. Plaintiffs have made numerous other allegations of misleading statements or omissions in their Complaint; they have thrown in the proverbial kitchen sink. But because Plaintiffs do not offer any evidence to support these allegations, these allegations present no genuine

(a.) Product Reliability and Defects

The IPO Prospectus disclosed that initial versions of Teddy Ruxpin were being returned by the consumers at a level higher than 10%. According to the IPO Prospectus, 10% was the expected return rate for toys similar to Teddy Ruxpin. However, the IPO Prospectus predicts that "product returns for [this] existing product line will be favorably affected by recent product modifications." Plaintiffs argue that this latter statement is false or misleading because WOW allegedly was already experiencing a substantially higher return rate at the time of the IPO.

Plaintiffs' evidence for this contention is flimsy at best. Plaintiffs present the testimony of some of WOW's customers that the return rate for Teddy Ruxpin at about the time of the IPO was over 20%. But this does not contradict the statement in the IPO Prospectus. The Prospectus predicts only that the return rate would decrease in the future as the modifications were implemented. Plaintiffs have no evidence that the return rate for Teddy Ruxpin *after* the modifications were made was higher than the rate before the modifications.

More importantly, WOW was not under any duty to disclose such information at all. There is no evidence that the return rate for Teddy Ruxpin had any effect upon WOW's sales of the product to retailers. Indeed, Teddy Ruxpin is still selling relatively well as of this date.[9]

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issues of fact, and are not considered by the court in deciding these motions.

[9] The Teddy Ruxpin line of products was sold to Hasbro.

Disclosure of the actual return rate was not required to make the statement in the Prospectus not misleading, unless the return rate posed a material risk to investors at the time of the IPO. Plaintiffs have shown no evidence that this was the case.

(b.) Poor Product Demand

Plaintiffs claim that the IPO Prospectus falsely expressed optimism about the demand for the Teddy Ruxpin line of products. They base this allegation on the mere fact that WOW was introducing new accessory items intended to extend the life cycle of the Teddy Ruxpin line. The IPO Prospectus states that "[t]he Company believes that the marketing of these related items . . . will help extend the life cycle of the product line."

This statement, however, does not constitute management's assurance that demand for the Teddy Ruxpin line would remain high. Even if it did, the IPO Prospectus adequately bespoke caution on the risks involved in investing in a company with only a single product line. Thus, any statement relating to the demand for Teddy Ruxpin is not misleading as a matter of law.

(c.) Inadequate Internal Controls

Plaintiffs contend that WOW's system of internal accounting controls was inadequate at the time of the IPO. They argue that the IPO Prospectus' silence on this matter was misleading. There is no evidence, however,

that WOW's system of internal controls presented a substantial business risk to investors at the time of the IPO. On the contrary, WOW had retained Deloitte to install an entirely new system shortly before the IPO.

Plaintiffs point to several documents dated after the IPO, in which certain employees of WOW indicated that the company's rapid growth made necessary further improvement of the internal control systems. These documents, however, are not relevant to the issue of whether, at the time of the IPO, WOW had a duty to disclose any information about the alleged inadequacy of its internal controls. The company need only disclose those risks material to an investor's decision to purchase the securities. WOW did not have a duty to disclose every possible risk, no matter how slight, that may have arisen in the future.

(d.) Extended Payment Sales

The IPO Prospectus states that "[t]he Company does not factor its accounts receivable and ships all of its products on terms requiring relatively prompt payment." Plaintiffs argue that this statement was false or misleading. They base this allegation solely upon the fact that in early 1986, WOW gave one customer extended payment terms on one order. Plaintiffs present evidence showing that in early 1986, defendant Kingsboro personally allowed Toys R Us to pay in 90 days or December 10, 1986, whichever was later, on an order of more than $3,700,000.

It is impossible for this court to hold that this one transaction makes the statement in the IPO Prospectus a violation of the securities laws. A few months may be considered "relatively prompt" among businesses when the amount to be paid is $3,700,000. Moreover, Toys R Us was the nation's largest toy retailer, as well as WOW's largest customer, so it is unlikely that WOW even could have bargained for better terms. Investors more likely would have felt misled by WOW's management if WOW had failed to enter this transaction.

In addition, Toys R Us paid in full in late 1986, and there is no evidence that this payment was ever in doubt. Thus, this transaction never posed a risk to WOW's investors, so WOW was not obligated to disclose its particulars.

(e.) Guaranteed Sales

Plaintiffs contend that the IPO Prospectus failed to disclose that WOW engaged in "guaranteed sales," that is, allowing its customers to return goods for a full credit or refund. The testimony of WOW's officers shows that, from time to time, WOW attempted to reach mutually acceptable accommodations with customers who had problems with unsold inventory of WOW's products. WOW on occasion would allow the unsatisfied customer to return the product in exchange for another product on a dollar-for-dollar basis.

Just because some of WOW's customers were allowed a refund does not mean that, at the time of the IPO, WOW had a practice of offering guaranteed sales to

all its customers. Giving an unsatisfied customer a refund is a normal business method of dealing with an unsatisfied customer. It is not a violation of the securities laws for WOW to fail to disclose such an obvious practice to potential investors.

Unless these alleged guaranteed sales were a substantial threat to WOW's revenues at the time of the IPO, WOW was under no duty to disclose them in the IPO Prospectus. Plaintiffs have no evidence that this was the case, so this omission cannot be said to have misled Plaintiffs.

(f.) Accounts Receivable

Plaintiffs allege that the IPO Prospectus was false and misleading regarding WOW's accounts receivable. Plaintiffs claim that WOW's accounts receivable were severely inflated at the time of the IPO. Plaintiffs argue that the fact that WOW was forced to write-off $3,000,000 of these accounts shortly after the IPO is evidence that the IPO Prospectus was misleading on this issue.

The IPO Prospectus, however, specifically warned that "a material portion" of WOW's accounts were over 90 days old, and that "excessive aging" of these accounts would adversely affect WOW's liquidity. Any reasonable investor was able to interpret "excessive aging" as meaning inability to collect payment, forcing WOW to take a write-off. In short, the IPO Prospectus adequately bespoke caution on the risks concerning WOW's accounts receivable.

(g.) WOW's Liquidity

Plaintiffs claim that the IPO Prospectus made statements about WOW's liquidity that were false and misleading. Specifically, they claim that WOW had less cash on hand than it anticipated. They also argue that WOW misled investors by projecting that its working capital "will be sufficient to meet the Company's short-term cash requirements through the end of fiscal 1987."

These are exactly the types of statements to which the bespeaks caution analysis applies. The "Risk Factors" section of the IPO Prospectus contained numerous statements that very nearly begged investors to take notice of WOW's serious liquidity problems. Not only did the IPO Prospectus disclose that WOW was using bank credit lines for its working capital, it disclosed the fact that WOW possibly would soon have to seek additional lines of credit or sell additional equity to meet its future capital requirements. Any investor in WOW assumed these risks. In the face of this cautionary language, Plaintiffs cannot claim to be misled by the company's prediction that it would continue to be liquid.

(h.) Summary

In sum, the court holds that the IPO Prospectus does not contain any false or misleading statements or omit any material risks that create liability under Section 11. Viewing the document as a whole, it clearly bespoke caution on the specific risk factors involved in investing in WOW. The alleged misrepresentations offered by Plaintiffs are trivial in nature compared to the extent of

the disclosure of material risks found in the document. No reasonable jury could find that any material aspect of the IPO Prospectus was false or misleading. Each defendant is entitled to summary judgment on Plaintiffs' claims based on the IPO Prospectus.

C. *The Debenture Prospectus*

1. *Risk Disclosure*

The Debenture Prospectus, much as the IPO Prospectus, contained a section under the heading of "Risk Factors." This section contained detailed disclosures of the myriad risks involved in investing in WOW, that are substantially identical to the factors listed in the IPO Prospectus, *supra* IV.B.1. In addition, the Debenture Prospectus made the following disclosures:

> **Competition.** Lazer Tag . . . [has] faced more immediate and significant competition than that faced by the Teddy Ruxpin product line in fiscal 1986.
>
> **Capital Requirements.** The Company's existing bank lines of credit and import financing line expire September 30, 1987 and December 31, 1987, respectively. To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts under these lines, both of which it expects to replace or extend prior to expiration. The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities currently being negotiated, will provide sufficient funds to meet

the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on acceptable terms, its operations would be adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

This latter section to which the potential investor is referred makes the following further disclosure:

Liquidity and Capital Resources

Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support its growth. The Company has met its capital requirements to date primarily through borrowings under bank lines of credit, the private and public sale of equity securities and borrowings under subordinated notes payable to shareholders.

. . . . At June 3, 1987, the Company had outstanding borrowings of approximately $80 million, representing the maximum amounts available under the borrowing limits of its bank line of credit.

In addition to the bank line of credit, the Company recently negotiated a $35 million unsecured import financing line which expires on December 31, 1987. As of June 3, 1987, the Company had standby letters of credit of approximately $32 million outstanding under this line.

The "Risk Factors" section also included cautionary statements regarding WOW's internal controls:

> **Systems and Control Procedures Requirements.** The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind its growth. While the Company continues to upgrade its systems, procedures and controls to meet the demands of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with growth.

2. *The Market's Knowledge of WOW's Business Risks*

There is substantial evidence that by the time of the Debenture offering, WOW's financial difficulties were widely known to the market. Plaintiffs are relying on a fraud on the market theory in this case. Thus, in addition to overcoming the bespeaks caution doctrine, Plaintiffs must show that a particular statement or omission made the Prospectus misleading in the light of all the information known to the market. *See Convergent Technologies*, 948 F.2d at 512.

Two prominent rating agencies, Moody's and Standard and Poor's, rated the debentures as "below investment grade" securities. Moody's rated the bonds B3, their lowest possible B rating. Moody's states that "[b]onds which are rated B generally lack the characteristics of a desirable investment. Assurance of interest and principal

payments over any long period of time may be small." Standard and Poor's rated the bonds B, which they define as:

> on balance, predominately speculative with respect to the issuer's capacity to pay interest and repay principal in accordance with the terms of the obligation. . . . While such bonds will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.

In other words, the major rating agencies classified these debentures as "junk bonds." That this fact was widely disseminated throughout the market is reflected by the 9% interest rate for the debentures, which was substantially higher than the market rate for lower risk securities.

Since WOW was widely considered in the marketplace to be a risky investment, Plaintiffs' allegations that statements in or omissions from the Debenture Prospectus were misleading deserve especially careful scrutiny by this court.

3. *Plaintiffs' Allegations and Evidence*

(a.) Alleged Errors in the Financial Statements

Plaintiffs allege numerous errors in the financial statements for 1987,[10] included in the back pages of the

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[10] Plaintiffs allege that there were errors in the 1986 financial statements as well, but they have produced no specific evidence on this issue. Accordingly, the court holds that there

Debenture Prospectus. These financial statements were prepared and certified by Deloitte. Plaintiffs contend that the financial statements are erroneous because Deloitte improperly recognized revenue on a number of WOW's transactions.

Even if this were the case, though, every defendant except Deloitte is entitled by statute to rely on Deloitte's expertise on accounting issues. Section 11(b)(3)(C) provides a defense to liability under Section 11 for statements certified by an expert where the defendant "had no reasonable grounds to believe and did not believe . . . that the statements therein were untrue." 15 U.S.C. § 77k(b)(3)(C). Here, Plaintiffs have admitted that WOW's management made full disclosure to Deloitte of all relevant information regarding the questioned transactions. It was Deloitte alone that made the decision to recognize the revenue.

Also, the issues are enormously complex on the question of whether Deloitte's recognition of revenues was in accordance with the standards of the accounting profession. The parties have generated well over 100 pages of conflicting expert testimony on these issues alone. It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistake by Deloitte. Therefore, even if there are errors in the financial statements,

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are no errors in the 1986 financial statements in either the Debenture Prospectus or the IPO Prospectus.

no defendant except Deloitte can be liable under Section 11 on that basis.[11]

(b.) Price Protection

Plaintiffs argue that the Debenture Prospectus was misleading because it did not disclose that WOW would offer "price protection" to its customers. According to Plaintiffs, WOW had a practice of crediting a customer's account if WOW dropped the price after making a sale to that customer. Plaintiffs claim that WOW was forced to take a write-down of $93 million in 1987, after the debenture offering, due to price protection.

The evidence shows, however, that WOW did not engage in any price protection prior to October, 1987, when it was forced to reduce the prices for its major product lines. There is no evidence that, at the time of the Debenture offering, WOW's management could have foreseen that WOW would have to reduce its prices to such an extent. Thus, the alleged practice of price protection did not pose a foreseeable risk to WOW's investors at the time of the debenture offering, so WOW had no duty to disclose it.

(c.) Alleged Collapse in Sales

The parties do not dispute that WOW's sales of its major product lines, Lazer Tag in particular, decreased dramatically in late 1987. Plaintiffs argue, though, that

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[11] The court discusses Deloitte's liability for the financial statements separately. *See infra* part IV.C.4.

this decrease was already occurring at the time of the Debenture offering, and that this fact should have been disclosed in the Debenture Prospectus.

Plaintiffs contend that the Debenture Prospectus should have disclosed that WOW's sales of Lazer Tag for April and May of 1987 were below plan. However, this "plan" is not material. A company has no duty to disclose its internal projections. *Convergent Technologies*, 948 F.2d at 516. The only question for the court is whether, at the time of the Debenture offering, Lazer Tag sales were declining so dramatically that WOW was required to disclose it in the Debenture Prospectus.

The Officer Defendants have submitted testimony that they believed the decline in Lazer Tag sales to be due to the normal seasonality of toy sales, which was adequately disclosed in the Debenture Prospectus. The Officer Defendants also offer testimony that they believed sales of Lazer Tag would increase by the Christmas season, which was reasonable given that Lazer Tag was a best selling toy during the prior Christmas season.

Plaintiffs submit no admissible evidence to show that WOW's sales had decreased so dramatically at the time of the Debenture offering that WOW's management could have known about, and thus would have had a duty to disclose, the impending collapse of Lazer Tag sales.[12]

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[12] Plaintiffs submit the declaration of John G. Forsythe, WOW's Credit and Collections Manager. Forsythe testifies that based on his conversations with WOW's customers, he knew that Lazer Tag sales were very poor. However, Forsythe had no responsibility for WOW's sales, so he has no personal knowledge of this fact and could not testify to it at trial. If he were [sic]

Plaintiffs cannot use the benefit of 20-20 hindsight to turn management's business judgment into securities fraud.

(d.) Internal Controls

Plaintiffs argue that the Debenture Prospectus was misleading for failing to disclose that WOW's internal control systems were facing serious problems. Plaintiffs ignore the fact the Prospectus included an express disclaimer that "there can be no assurances" that WOW's existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke caution regarding this potential risk to WOW's investors. As a matter of law, Plaintiffs cannot have been misled.

(e.) Alleged Misstatement Concerning WOW's Continued Liquidity

Plaintiffs claim that WOW's prediction that it could meet its capital needs until the end of March, 1988 was misleading, given the fact that WOW filed for bankruptcy in December, 1987. However, the disclosures in the Debenture Prospectus cited by the court, *supra* IV.C.1.,

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testify to the fact that various retailers told him sales were poor, it would be inadmissible hearsay. Thus, none of Forsythe's testimony about Lazer Tag sales would be admissible at trial, and it is not considered by the court in deciding these summary judgment motions.

clearly bespoke caution on the serious risks WOW's liquidity crisis posed to investors. The Debenture Prospectus disclosed that WOW's existing credit lines were extended nearly to the limit, that WOW's receivables had never been sufficient to meet WOW's capital requirements, and that an unforseen decline in demand would seriously affect the company. Plaintiffs are not entitled to an inference that they were misled in the face of these disclosures. Indeed, if courts were to allow plaintiffs in securities fraud cases to survive summary judgment in the face of disclosures this detailed and specific, there would be no point for companies to disclose risks at all. It is not the function of the securities laws to provide investors with insurance against disclosed risks.

(f.) Summary

To summarize, none of the defendants, with the possible exception of Deloitte, can be held liable under Section 11 for the Debenture Prospectus. Putting aside the issue of alleged errors in the 1987 financial statements, this court holds that there are no statements in, or omissions from, the Debenture Prospectus that would give rise to an inference that any part of the document was false or misleading. Summary judgment therefore is appropriate in favor of all defendants except Deloitte on this portion of Plaintiffs' claim.

4. Deloitte's Section 11 Liability for Alleged Errors in the 1987 Financial Statements

Plaintiffs allege that Deloitte erroneously recognized revenues on certain of WOW's significant transactions in fiscal 1987. According to Plaintiffs, this makes false or misleading the 1987 financial statements included in the Debenture Prospectus, which were certified by Deloitte.

Deloitte does not concede that it made any accounting errors in recognizing revenue on the questioned transactions. As mentioned above, this issue is the subject of an extensive battle of experts between Deloitte's accountants and Plaintiffs' expert witness. However, Deloitte alternatively seeks summary judgment on Plaintiffs' Section 11 claim based on two affirmative defenses. First, Deloitte asserts that it exercised "due diligence" in investigating the questioned transactions, so it is not liable even if its recognition of revenue was erroneous. Second, Deloitte contends that it is not liable because Plaintiffs' losses were not caused by its alleged misstatements.

As is set forth below, this court believes that Deloitte's "loss causation" defense entitles it to summary judgment. Therefore, the court does not reach the issues of whether the financial statements are erroneous or whether Deloitte is entitled to a due diligence defense.

Damages for a Section 11 violation are measured by the difference between the amount paid for the security and its price at either the time it was sold or the date the Section 11 claim was filed. *See* 15 U.S.C. § 77k (e). Section 11(e), however, provides that:

> [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is being asserted, not being true . . . such portion or all of such damages shall not be recoverable.

Id. The defendant has the burden of proof on this defense. *Id.* Though it has been recognized by courts as a "heavy burden," it is not insurmountable, and courts have awarded summary judgment to the defendant in appropriate cases. *See In re Fortune Systems Securities Litigation,* 680 F.Supp. 1360, 1364-65 (N.D.Cal.1987).

This is such a case. It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debentures' decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. Since the marketplace never knew of any alleged accounting errors, the alleged errors cannot be said to have had any effect on the Debentures' market value.

Plaintiffs try to escape this inevitable conclusion by arguing that they purchased the debentures at an artificially high price because the market was misinformed by the erroneous financial statements. Thus, Plaintiffs contend, they have sustained damage caused by Deloitte's alleged errors. This argument, though true in

theory, mistakes the relevance of transaction causation, as opposed to loss causation, in Section 11 claims. Transaction causation is inferred from a showing either that the plaintiffs would not have purchased the security but for defendant's misrepresentation, or that they would have purchased it at a lower price. Transaction causation is relevant to claims under other securities laws, in particular Rule 10b-5.

Congress, however, expressly chose a different measure of damages for Section 11 violations. Damages for a Section 11 violation are simply the difference between the price at which the plaintiff purchased the security and the price on the day it was sold. 15 U.S.C. § 77k (e). Transaction causation is plainly irrelevant under this statutory formula.

Moreover, it is clear that the defense provided for in Section 11(e) addresses loss causation and not transaction causation. As the court in *Fortune Systems* held in applying Section 11(e), "[w]hen a portion of the plaintiff's loss is due to an independent intervening cause, such as a decline in the stock market . . . the defendant cannot be held liable for that portion of the plaintiff's loss." 680 F.Supp. at 1365 (quotations omitted). Congress simply did not intend that those who violate Section 11 must insure investors against all possible business risks. *See id.*

Absent any showing of fraudulent intent, it would be extremely unjust to subject a defendant such as Deloitte to full liability for the collapse of a business merely because it may have made some accounting mistakes. Thus, for the above reasons, summary judgment is granted in favor of Deloitte on its loss causation defense.

Deloitte is not liable under Section 11, as a matter of law, for any errors in the 1987 financial statements.

V. PLAINTIFFS' SECTION 12(2) CLAIMS

Plaintiffs' Seventh and Eighth Claims for Relief allege that the Underwriter Defendants violated Section 12(2) of the Securities Act of 1933. Section 12(2) provides that "[a]ny person who offers or sells a security . . . by the means of a prospectus . . . which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable to the person purchasing such security." 15 U.S.C. § 77*l*(2).

The analysis this court applied to Plaintiffs' Section 11 claims, *supra* part IV., applies equally to Plaintiffs' claims under Section 12(2). This court repeats its holding that there are no misleading statements in or material omissions from the prospectuses, aside from possible errors in the 1987 financial statements prepared by Deloitte in the Debenture Prospectus.[13]

Regarding the alleged errors in the 1987 financial statements, only Smith Barney is named as a defendant in

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[13] The court emphasizes again that it is far from certain that there are any errors in the financial statements prepared by Deloitte. The court simply is conserving judicial resources by assuming *arguendo* that the statements are in error, because summary judgment for defendants is clearly appropriate on other grounds.

Plaintiffs Section 12(2) claim on the Debenture Prospectus. Section 12(2) provides a defense for a defendant who proves that "he did not know, and in the exercise of reasonable care could not have known" of the alleged error. *Id.* The financial statements, as mentioned above, were "expertised" by Deloitte, and Smith Barney had no duty to independently repeat the investigation done by Deloitte. Even so, as part of Smith Barney's "due diligence" inquiry, Smith Barney specifically sought and received assurances from Deloitte on the facts that supported Deloitte's decision to recognize revenue on the questioned transactions. Thus, Smith Barney clearly exercised reasonable care, and it did not have any reason to know that there were any errors in the financial statements.

For the above reasons, the Underwriter Defendants are entitled to summary judgment on Plaintiffs' Section 12(2) claims.

VI. PLAINTIFFS' RULE 10b-5 CLAIMS

Plaintiffs allege claims against all defendants for violations of Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder. Section 10(b) provides in relevant part that "it shall be unlawful for any person . . . to use or employ, in connection with the purchase of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j (b). Securities and Exchange Commission Rule 10b-5, which implements Section 10(b), provides:

> It shall be unlawful for any person . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10(b)(5).

In addition, the Supreme Court has held that for a defendant to be liable under Rule 10b-5, there must be a showing of scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 194 & n. 12, 96 S.Ct. 1375, 1382 & n. 12, 47 L.Ed.2d 668 (1976). The Ninth Circuit has held that scienter can be proved by a showing of recklessness on the part of the defendant. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir.1990), *cert. denied,* ___ U.S. ___, 111 S.Ct. 1621, 113 L.Ed.2d 719 (1991). For the purposes of Rule 10b-5, reckless conduct is defined as conduct

> involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.1977), *cert. denied*, 434 U.S. 875, 98 S.Ct. 224, 54 L.Ed.2d 155 (1977)).

It is beyond dispute that summary judgment can be granted on the issue of scienter in an appropriate case. *In re Apple Computer Securities Litig.*, 886 F.2d 1109, 1113 (9th Cir.1989), *cert. denied*, 496 U.S. 943, 110 S.Ct. 3229, 110 L.Ed.2d 676 (1990). Plaintiffs must offer more than conclusory allegations, and if the defendants present evidence establishing a lack of scienter, Plaintiffs must produce some affirmative evidence to avoid summary judgment. *See Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434, 1436 (9th Cir.1984). Furthermore, where the evidence presents a pattern of conduct inconsistent with scienter, the non-movant bears a heavy burden in defeating summary judgment with inferences drawn from circumstantial evidence. *See Apple Computer*, 886 F.2d at 1118 (no inference of scienter where "overall pattern of conduct" inconsistent with bad faith); *see also In re Software Toolworks, Inc. Securities Litig.*, 789 F.Supp. 1489, 1498-1500 (N.D.Cal.1992) (same).

Plaintiffs base their claims under Rule 10b-5 primarily on the alleged misstatements or omissions in their prospectuses that the court addressed in part IV, *supra*. The analysis this court applied to Plaintiffs' Section 11 claims also applies to Plaintiffs' Rule 10b-5 claims, to the extent the Rule 10b-5 claims are based on the prospectuses. It bears repeating, then, that as a matter of law, there are no misrepresentations in, or material omissions from, the IPO Prospectus. Also, as a matter of law, there are no misleading statements in, or material omissions

from, the Debenture Prospectus, aside from possible errors by Deloitte in the 1987 financial statements.

Plaintiffs also base their Rule 10b-5 claims, though, on alleged fraudulent conduct by the defendants other than the prospectuses. Each defendant, without conceding that it engaged in any misleading conduct, moves for summary judgment on the ground that Plaintiffs cannot show scienter on the part of the defendants. The court addresses the evidence on scienter as to each defendant in turn.

A. *The Officer Defendants*

Aside from the prospectuses, Plaintiffs allege in conclusory fashion that the Officer Defendants violated Rule 10b-5 by misleading "press releases, filings with the SEC, statements to analysts, etc." The Officer Defendants overall pattern of conduct, though, rebuts any inference of knowing or reckless conduct on their part. If WOW's officers were bent on committing fraud, it is not likely that they would have provided such detailed risk disclosure in the prospectuses. Furthermore, if, as Plaintiffs allege, the Officers knew that WOW was heading for financial disaster, they probably would have bailed out of their substantial stock holdings. Each of the Officer Defendants, by contrast, held onto most of their WOW stock and incurred the same large losses as did the Plaintiffs themselves. Stein did not sell any of his holdings until after WOW filed for bankruptcy. Pezzani did not sell at all. Kingsboro sold only a small fraction of his stock, and that was pursuant to a prearranged plan developed by his financial advisor.

In addition, each of the Officer Defendants has submitted an affidavit stating that they acted in good faith regarding all of their dealings with WOW.

Plaintiffs' slim evidence of specific facts does not give rise to a inference of scienter when considered with the Officer Defendants' evidence. Plaintiffs point to statements attributed to defendant Kingsboro in the magazine *California Business* in 1986, before the class period began. Plaintiffs allege that Kingsboro's statements in the article were misleading.[14] WOW's public relations firm wished to reprint and circulate the magazine article, which was largely favorable to WOW. WOW's management, however, decided not to do so after consultation with their attorneys. Plaintiffs argue that the fact that the statements in the article were never formally corrected is probative of scienter on the part of the officers, even though the Officer Defendants do not concede that the statements were false, and Plaintiffs have no evidence on this point.

Plaintiffs, however, neglect to mention three key facts that rebut any inference of scienter. First, even if the statements in the article were false, WOW decided against reprinting the article. Second, the IPO Prospectus provided substantial risk disclosure that would have overwhelmed any misleading effect the magazine article could have had on the market. If the Officer Defendants were attempting to mislead the market, they would not have provided such ample risk disclosure to investors.

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[14] Plaintiffs do not submit any evidence showing that any of the statements were misleading. For that matter, Plaintiffs do not even point out to the court exactly which statements in the article they claim are misleading.

Third, Plaintiffs do not have any evidence to show that Kingsboro knew or could have known that the statements attributed to him in the article were false.

Plaintiffs also point to a statement Kingsboro made to the press in connection with WOW's earnings report for the fourth quarter of fiscal 1987. Kingsboro attributed the drop in WOW's earnings to "substantial investment in engineering and product development." Plaintiffs contend that it was due in fact to decreased sales. However, WOW did actually invest substantially in engineering and product development, and Plaintiffs have no evidence to suggest that Kingsboro's statement was false.

Plaintiffs' evidence shows only that they will grasp wildly at any straw in hope of saving their securities fraud claims against the Officer Defendants. There is no evidence of scienter on the part of any of the Officer Defendants. They are entitled to summary judgment on Plaintiffs' Rule 10b-5 claims.

B. *The Underwriter Defendants*

Plaintiffs' Rule 10b-5 claims against the Underwriter Defendants are based almost exclusively on the prospectuses, which, as the court discussed at *supra* part IV., do not support any inference that Plaintiffs were misled by these defendants.

Plaintiffs' claim against Dean Witter is based entirely on the IPO Prospectus. Thus, Dean Witter is awarded summary judgment on Plaintiffs Rule 10b-5 claim.

Aside from the prospectuses, the only alleged fraudulent conduct on the part of Smith Barney is an August

14, 1987 analyst report prepared by Stephen Handley of Smith Barney which recommended WOW stock to investors. Even though this report actually downgraded Smith Barney's earlier recommendation on WOW from "long term buy" to "accumulate," Plaintiffs contend that it was misleading. However, an analyst report containing opinions made in good faith is *per se* not made with scienter. *Software Toolworks,* 789 F.Supp. at 1501. Plaintiffs do not challenge the good faith basis for Handley's recommendation. Thus, summary judgment is awarded to Smith Barney on Plaintiffs' Rule 10b-5 claims.

C. *Deloitte*

As mentioned above, Deloitte was responsible for the 1987 financial statements that appear in the Debenture Prospectus. Plaintiffs have presented evidence, in the form of the declaration of an expert witness, that Deloitte erroneously recognized revenue on certain of WOW's transactions, which according to Plaintiffs makes the financial statements misleading under Rule 10b-5. This evidence creates a genuine issue of fact on this element of Plaintiffs' Rule 10b-5 claim.

To survive summary judgment, however, Plaintiffs also must come forward with evidence from which a jury could infer scienter on the part of Deloitte. Even assuming that Deloitte was incorrect in recognizing the revenues, Deloitte has not violated Rule 10b-5 unless it acted knowingly or recklessly in erroneously recognizing the revenues.

Deloitte has submitted evidence showing that it extensively investigated, carefully addressed, reasonably resolved, and thoroughly documented every transaction where Plaintiffs allege revenue was improperly recognized. Also, Deloitte submits the declarations of its accountants that recognition of the revenue was proper in accordance with Generally Accepted Accounting Principles ("GAAP"). The thoroughness of Deloitte's investigation into the transactions in question certainly meets Deloitte's burden of showing that there is no genuine issue of fact on the issue of scienter.

Plaintiffs respond to Deloitte's evidence with the declaration of Albert Rossi, an expert witness according to Plaintiffs. Rossi's testimony, in substance, is that for everything Deloitte's accountants did, he would have done more, and that in his opinion, the revenues were improperly recognized under GAAP. Rossi concludes that "[t]he danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it."

As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. *Apple Computer,* 886 F.2d at 1116. "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any inference of bad faith. *See Software Toolworks,* 789 F.Supp. at 1504 n. 30.

Here, Rossi's conclusory opinion that Deloitte's accountants had a mental state of knowledge or recklessness is not enough to allow a jury to infer scienter. Rossi's opinion is not based on specific facts that shed light on the mental state of Deloitte's auditors, and from which the jury on their own could infer scienter. Rather, Rossi is drawing his conclusion based on a record that conclusively rebuts any inference of scienter. *See Apple Computer,* 886 F.2d at 1118 (no inference of scienter where overall pattern of conduct inconsistent with bad faith). As such, Rossi's opinion is more probative of Plaintiffs' desperation to keep Deloitte, a "deep pocket," involved in this lawsuit than it is on the issue of whether Deloitte acted with scienter. Rossi's declaration does not help Plaintiffs survive Deloitte's motion for summary judgment.[15]

The court holds that as a matter of law Plaintiffs cannot establish scienter on the part of Deloitte. Deloitte is awarded summary judgment on Plaintiffs' Rule 10b-5 claims.

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[15] The court wishes to make clear that it is not striking Rossi's declaration, but granting summary judgment notwithstanding it.

Interestingly, this is not the first time that a district court has awarded summary judgment to an auditor on the scienter issue in the face of a declaration by Rossi. In *Software Toolworks,* the plaintiffs' asserted a Rule 10b-5 claim against Deloitte. After finding nothing in the record indicating scienter, the court awarded summary judgment in favor of Deloitte, even though an expert had opined that Deloitte had acted knowingly or recklessly. *See Software Toolworks,* 789 F.Supp. at 1504-10. Deloitte has informed the court that Rossi was the expert whose testimony was rebuffed by the court in that case.

D. *Plaintiffs' Insider Trading Claims*

The only colorable Rule 10b-5 claim that Plaintiffs allege against defendants Howenstein, Margolis, Abercrombie, Robinson, and WOW Shares Partnership is for insider trading.[16] Though the Ninth Circuit has not expressly recognized a private right of action under Rule 10b-5 for insider trading, other courts have implied this right. *See, e.g., Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 94-95 (2d Cir.1981).

Plaintiffs assert that since these defendants sold some of their shares in WOW prior to WOW's financial collapse, they must have known of some information, not already known to the market, that signalled WOW's imminent doom. Plaintiffs "evidence," though, consists of mere speculation and conclusory allegations. For example, according to Plaintiffs, Howenstein, as a director of WOW, must have had knowledge of inside information. Plaintiffs allege, without any proof, that Howenstein sold

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[16] Plaintiffs also allege that Howenstein and Margolis violated Rule 10b-5 in connection with the IPO Prospectus and the Debenture Prospectus, but the court has held that none of the statements in the prospectuses for which these defendants would be responsible are actionable under Rule 10b-5. *See supra* part IV.

Plaintiffs also allege, as a separate basis for their Rule 10b-5 claim, that Howenstein and Margolis violated Rule 10b-5 by "misrepresentations and omissions during the class period." Nowhere in their memorandums submitted in opposition to these motions do Plaintiffs specify what these alleged misrepresentations or omissions were. The court assumes that this is because there is no evidence to support these allegations. Thus, this portion of Plaintiffs' claim presents no genuine issues of fact, and summary judgment is appropriate.

some of his shares of WOW stock based on information not known to the market, as opposed to information disclosed by WOW.

Furthermore, Howenstein was Abercrombie's business manager, so Howenstein had many opportunities where he could have tipped Abercrombie on inside information. Since Abercrombie later sold a portion of her stock, she too must be guilty of insider trading, according to Plaintiffs. Plaintiffs also point out to the court that the president of Robinson met with Howenstein on numerous occasions, as if this was some sort of smoking gun that implicates Robinson in this alleged scheme of insider trading.

Plaintiffs follow a similar line of reasoning regarding Margolis and WOW Shares Partnership. Margolis, a director of WOW, had access to inside information. Again, without any proof, Plaintiffs allege that when Margolis sold a portion of his shares, it was based on this inside information. Since Margolis was a partner in WOW Shares Partnership, he had the opportunity to tip the other partners on inside information. WOW Shares Partnership sold some of its shares. Thus, according to Plaintiffs, illegal insider trading by WOW Shares Partnership also must have occurred.

Plaintiffs contend that their evidence is enough to survive summary judgment on their claims of insider trading. The evidence, though, shows only that the opportunity for insider trading existed. Plaintiffs cannot survive summary judgment merely by showing that the opportunity existed. Plaintiffs must point out with specificity, and present some proof of, the material nonpublic

information that was allegedly traded upon. In this case, after years of discovery, Plaintiffs cannot point to any bit of information traded on by these defendants that was not already known to the market. This speaks to the merits of their claims.

Moreover, even if there were some evidence that these defendants' sales of WOW stock were based on inside information, Plaintiffs have submitted no evidence from which the jury could infer scienter. "Insider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer,* 886 F.2d at 1117. But in this case, when one considers the amounts traded, Plaintiffs' claims appear fantastic. These defendants sold only a small portion of their holdings in WOW. Of course, an insider trader may not always trade all his shares in the company for which he possesses the inside information; the trader may hold on to a portion of his shares to hedge against the unforseen or to obscure the insider trading from the SEC. Here, however, Plaintiffs' allegation is essentially that these defendants possessed inside information on WOW's imminent collapse, so one would expect that they would have sold a good proportion of their holdings.

On the contrary, most of these defendants sold only a minuscule fraction of their holdings in WOW,[17] and

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[17] Robinson was the only defendant that sold a majority of its shares in WOW. Robinson, however, has submitted unchallenged evidence that it sold its shares because it faced a pressing need to service a huge debt incurred from overinvesting in real estate. Moreover, Robinson sold its stock according to a prearranged plan that conformed to SEC regulations. This rebuts any inference of scienter on the part of Robinson.

ended up reaping the same large losses as did Plaintiffs when WOW collapsed. For example, Howenstein sold only 50,000 shares before WOW's bankruptcy, though he possessed over 970,000. Abercrombie sold only about fourteen percent of her shares, holding onto approximately 2,870,000 shares that became essentially worthless after WOW's bankruptcy. Some of the partners in WOW Shares Partnership who supposedly possessed inside information did not sell at all.

In sum, with this evidence, no reasonable jury could find that insider trading had occurred, or that these defendants acted with scienter. Plaintiffs' Rule 10b-5 claims against Howenstein, Margolis, Abercrombie, WOW Shares Partnership, and Robinson are without merit. Summary judgment is granted in favor of the defendants on these claims.

VII. PLAINTIFFS' CLAIMS OF SECONDARY LIABILITY

Plaintiffs' Second and Ninth Claims for Relief allege claims of secondary liability under Section 20 of the Exchange Act, 15 U.S.C. § 78t (a), and Section 15 of the Securities Act, 15 U.S.C. § 77o, respectively. These sections provide that any defendant who controls a person liable under the securities laws is jointly and severally liable to the same extent as the controlled person.[18]

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[18] Section 20 of the Exchange Act provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally." 15 U.S.C.

In this case, the court has held that none of the defendants is liable under the federal securities laws. There being no primary liability, there can be no secondary liability. Thus, the court grants summary judgment for defendants on these claims.

VIII. PLAINTIFFS' STATE LAW CLAIMS

Plaintiffs' Third and Fourth Claims for Relief allege claims for state law fraud and negligent misrepresentation, respectively. Because the court intends to dismiss the federal claims in this case, it declines to further exercise its supplemental jurisdiction over Plaintiffs' state law claims.[19]

IX. CONCLUSION

When a company fails, it does not automatically mean that a violation of the securities laws has occurred. There are a number of risks involved whenever one invests in any company. The function of the federal securities laws is to provide investors with full disclosure of

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§ 78t (a). This section creates joint and several liability for Rule 10b-5 violations.

Section 20 of the Securities Act provides that "[e]very person who . . . controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally." 15 U.S.C. § 77o. This section creates joint and several liability for violations of Section 11 and Section 12(b) of the Securities Act.

[19] "The district courts may decline to exercise supplemental jurisdiction over a claim . . . if . . . the district court has dismissed all claims over which it has original jurisdiction. . . ." 28 U.S.C. § 1367(c)(3).

these risks, and to prevent fraud. The securities laws do not insulate investors against stock downturns which are caused by events that were not foreseeable to the company's management, nor do they provide insurance against risks that were disclosed to investors at the time they purchased the securities.

In this case, WOW's investors took a gamble, as do all investors. They lost. Holders of shares and Debentures knew that WOW was not a diversified company. Its success was based on only two major products, Teddy Ruxpin and Lazer Tag. Also, WOW's precarious cash position was not concealed from these investors; it was adequately revealed in both the IPO Prospectus and the Debenture Prospectus. It was obvious to any reasonable investor that if either of WOW's two products were to lose favor with consumers, the company would be devastated. Though WOW's failure was extraordinary, the material risks involved in investing in WOW were adequately disclosed to potential investors.

Plaintiffs have submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. The court has thoroughly reviewed the record, and it concludes that there is no issue on Plaintiffs' claims under the federal securities laws that can be submitted to the jury. For the reasons set forth above, no defendant is liable for any statement in, or omission from, either the IPO Prospectus or the Debenture Prospectus. Moreover, there is insufficient evidence,

as a matter of law, for the jury to find intent to deceive or defraud on the part of any defendant in connection with WOW's securities offerings.

The defendants' motions for summary judgment are GRANTED. This action is hereby DISMISSED.

IT IS SO ORDERED.

JUDGMENT

In accordance with the order entered by the court herein, summary judgment is GRANTED on Plaintiffs' federal claims in favor of the following defendants:

> Angelo M. Pezzani; Donald D. Kingsboro; Richard B. Stein; John B.Howenstein; Barry H. Margolis; Deloitte & Touche; Smith Barney, Harris Upham & Co., Inc.; Dean Witter Reynolds, Inc.; Josephine E. Abercrombie; Worlds of Wonder Shares Partnership; and Robinson Interests, Inc.

Plaintiffs' state law claims are hereby DISMISSED.

IT IS SO ORDERED.

ORDER DENYING PLAINTIFFS' MOTION TO RECONSIDER UNDER FED.R.CIV.P. 59; 60

I. INTRODUCTION

This action arises out of the collapse of Worlds of Wonder, Inc. ("WOW"), a high-technology toy company. Plaintiffs, a class of purchasers of WOW stock and debentures, brought an action under the federal securities laws against various individuals and firms involved in WOW's securities offerings. On January 20, 1993, this court

entered an Order granting summary judgment in favor of every defendant (the "Order"). See page 850. Plaintiffs now move the court to reconsider its Order.[1]

II. STANDARD OF REVIEW ON MOTIONS TO RECONSIDER

This court has the inherent power to modify or change its orders to correct a mistake or error. 6A *Moore's Federal Practice* ¶ 59.07 (1991). However, a motion for reconsideration is not the proper vehicle for revisiting issues that were decided, *Van Skiver v. United States*, 952 F.2d 1241, 1243 (10th Cir.1991), or for a "recapitulation of the cases and arguments considered by the court before rendering its original decision," *Starr v. JCI Data Processing Inc.*, 767 F.Supp. 633, 635 (D.N.J.1991). The party moving for reconsideration must show more than a disagreement with the court's decision; the court should not grant the motion unless there is a need to correct a clear error of law or prevent manifest injustice. *See Kern-Tulare Water District v. City of Bakersfield*, 634 F.Supp. 656, 665 (E.D.Cal.1986), *aff'd in part and rev'd in part on other grounds*, 828 F.2d 514, *cert. denied*, 486 U.S. 1015, 108 S.Ct. 1752, 100 L.Ed.2d 214 (1988).

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[1] Plaintiffs filed their notice of appeal to the Ninth Circuit Court of Appeals on February 18, 1993.

III. DISCUSSION

Plaintiffs filed two separate motions to reconsider. Plaintiffs filed a "Motion for Reconsideration and Alteration and Amendment of Judgment in Favor of Officer and Director Defendants and Defendant Smith Barney, Harris Upham & Co., Inc." In this motion, plaintiffs ask the court to reopen the case to reconsider issues that the court already decided. Specifically, they ask the court to reconsider its application of the "bespeaks caution" doctrine, and to reevaluate each of plaintiffs' contentions that certain statements in or omissions from WOW's prospectuses misled investors. This motion presents no new issues of law or fact. Therefore, the court denies this motion in its entirety.

Plaintiffs also filed a "Motion for Reconsideration and Alteration and Amendment of Judgment in Favor of Defendant Deloitte and Touche." Again, this motion presents no newly discovered facts or law showing that the court's Order was in error. Plaintiffs simply challenge the court's analysis. However, the court believes that some clarification of its Order would be helpful to the parties.

A. *The "Loss Causation" Defense of Section 11(e)*

To recall, Deloitte & Touche ("Deloitte") was WOW's independent auditing firm. Deloitte prepared and certified the financial statements WOW included in the prospectus for its debenture offering (the "Debenture Prospectus"). WOW's debentures greatly decreased in value after WOW defaulted on its first interest payment to debenture holders and declared bankruptcy.

The plaintiff subclass of debenture holders claims it is entitled to damages under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k. According to plaintiffs, the financial statements in the Debenture Prospectus overstated WOW's net revenues for fiscal 1987 by 14.3%[2]. Deloitte allegedly violated Section 11 by allowing this misleading information to appear in the Debenture Prospectus with Deloitte's certification.

Section 11(e) allows a prevailing plaintiff "to recover such damages as shall represent the difference between the amount paid for the security . . . and (1) the value thereof at the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit. . . . " 15 U.S.C. § 77k(e). However, Section 11(e) allows a defendant to avoid liability by proving that the decline in the price of the security resulted from factors "other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is being asserted, not being true." *Id.*

This court granted summary judgment to Deloitte based on its Section 11(e) "loss causation" defense.[3] (Order at 41.) The court held that the market price of

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[2] In their opposition to Deloitte's motion for summary judgment, Plaintiffs submitted the testimony of an expert witness that Deloitte erroneously recognized revenue on some of WOW's major transactions in fiscal 1987. The 14.3% figure is supplied by plaintiffs' counsel based on this expert's declaration.

[3] The court expressly did not reach the merits of Deloitte's "due diligence" defense.

WOW's debentures declined for reasons other than the alleged overstatement of revenues by Deloitte. The court found that Deloitte's alleged errors never were disclosed to the public. Since there was no public disclosure of the fact that WOW's 1987 revenues may have been overstated, the market could not possibly have reacted. (*See* Order at 866-67.) The court found instead that the debentures declined in value because the market discovered that WOW was barely liquid, and faced increasing difficulties in selling its products. (Order at 866-67.)

Plaintiffs contend, as they did in opposing Deloitte's motion for summary judgment, that they purchased the debentures at an artificially high price due to the market's reliance on Deloitte's alleged errors. Therefore, when WOW collapsed, plaintiffs suffered a greater loss than they otherwise would have suffered. Plaintiffs claim that this loss is recoverable under Section 11.

The argument pressed by plaintiffs is best illustrated by the district court in *In re Washington Public Power Supply System Securities Litigation*, 650 F.Supp. 1346 (W.D.Wash.1986) [hereinafter *Washington Power*].[4] In that case, the court proposed the following hypothetical: An investor buys stock in a shipping venture which owns one single vessel. The prospectus overstates the amount of capacity in the boat. However, the prospectus discloses truthfully that the vessel will not be insured. Suppose a storm destroys the vessel, and the investor's stock

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[4] This case was not brought to the court's attention by either Plaintiffs or Deloitte before its Order was entered.

becomes worthless. What damages would the investor be entitled to? *See id.* at 1353-54.

The court in *Washington Power* made the following observations:

> The misrepresentation may not be the cause of the loss; it is however, the cause of damage. By misrepresenting the capacity in the ship, the investor was induced to pay a certain price for stock in the venture. As a result of the misrepresentation, the investor paid more for the stock than it was worth. When the ship sank, the entire investment was lost. The investor, however, was injured by more than the true value of the investment because he paid an inflated price for the stock. The damages thus consist of two components: the value lost due to the casualty and the amount lost because he overpaid for the stock.

Id. The court concluded that the amount lost due to overpayment would be recoverable in an action under Rule 10b-5.[5] *Id.* Plaintiffs argue that under this reasoning, even if WOW's collapse is wholly unrelated to Deloitte's alleged errors, they are entitled to damages measured by the difference between the price they paid for the debentures and their "true value" at the time of purchase, that is, the price the debentures would have commanded from

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[5] Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10(b)(5), is promulgated pursuant to Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b). Rule 10b-5 creates a private right of action to remedy fraudulent conduct in connection with a securities offering.

the market in the absence of Deloitte's alleged misstatement of revenues. Plaintiffs now move the court to reconsider this portion of its Order.

To understand why Deloitte's "loss causation" defense of Section 11(e) applies in this case, one must consider the "fraud on the market" theory, on which plaintiffs rely. In a fraud on the market case, the plaintiffs do not have to prove individual reliance on the allegedly misleading information. Instead, the plaintiffs' claim that the misleading information was immediately disseminated throughout the market by those persons who did rely on it, thereby increasing the market price of the security. It necessarily follows under this theory that plaintiffs suffer no cognizable loss from the misleading information until the market learns of the falsehood of the information and adjusts accordingly. Until the false or misleading nature of the information is publicly disclosed, the price of the security remains inflated. Investors could sell their securities at any time before disclosure without suffering a loss.

It is helpful to consider a variation of the hypothetical set forth in *Washington Power* for illustration. Suppose the investor paid $100 for his stock in the shipping venture. This was the market price at the time of purchase. But unknown to the market, the boat's capacity is considerably less than was disclosed in the prospectus. If the true capacity were disclosed, the market price of the investor's shares would have been $75. Therefore, the investor's stock was overpriced by $25. Now suppose the boat is damaged in a storm, but does not sink. The market would react, and the price of the stock would decline, to perhaps $50 (to choose an arbitrary number).

If, however, the market has not yet learned the true capacity of the vessel, the stock is still overpriced by $25 (assuming all other variables affecting the shipping venture remain constant).

In the above example, the misleading prospectus did not cause the loss suffered by the investor. Under section 11(e), the defendant responsible for the error in the prospectus can prove that the investor's loss was caused by the storm, not by the misleading information about the boat's capacity. The defendant would be entitled to summary judgment.

Now assume instead that one day after the investor purchases the stock, the boat sinks in a storm, and the loss is total. This reduces the market value of the investor's stock to $0. Upon inspecting the wreckage, the investor learns of the mistake in the boat's capacity. He now claims he would have paid only $75 for his stock, and seeks to recover the overpayment of $25 from the person responsible for the misleading statement in the prospectus. There is no reason to change the analysis in the first example simply because the loss caused by the storm in this case is total. The storm, not the misleading prospectus, is still the direct cause of the loss. To allow recovery would convert the person responsible for the misleading information into an insurer against all possible casualties to the boat, not just those risks directly related to the defendant's misleading conduct.[6]

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[6] To be fair, recovery would only be for the amount overpaid ($25) and not the full amount of the casualty ($100). To allow recovery, then, would only put the defendant in the position of a partial insurer. However, the important point is that the

Thus, when plaintiffs proceed under a fraud on the market theory, the defendant is entitled to summary judgment on the loss causation defense of Section 11(e) upon an unrebutted showing that the misleading nature of the statements complained of was never revealed to the market. Indeed, this is the view of the small number of courts that have addressed this issue directly. *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir.1987); *In re Fortune Systems Sec. Litig.*, 680 F.Supp. 1360, 1368 (N.D.Cal.1987).

Plaintiffs cite to numerous cases which, according to plaintiffs, allow the recovery of the amount overpaid by investors due to the market's reliance on false or misleading statements. *See Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461 (9th Cir.1990), *rev'd on other grounds*, ___ U.S. ___, 112 S.Ct. 1311, 117 L.Ed.2d 532 (1992); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433 (9th Cir.1987); *Washington Power*, 650 F.Supp. 1346. These cases, however, all involve claims under Rule 10b-5 and not Section 11, and therefore are inapposite here.

It is no accident that the measures of damages for Section 11 violations and Rule 10b-5 violations are different. Rule 10b-5 is a catch-all provision that provides a remedy for any misleading conduct made in connection with the purchase or sale of securities, provided that the defendant possessed fraudulent intent, or scienter. The broad "loss causation" standard applied in the Rule 10b-5 cases cited by plaintiffs is judicially created to deter

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insurance would be for risks unrelated to the defendant's role in the securities offering. By including the "loss causation" defense in the statute Congress meant to exclude this result.

fraudulent conduct. The measure of damages, the difference between the price paid for the security and its "true value", is similar to the remedy provided in common law fraud cases.

By contrast, Section 11 is not a fraud provision. Section 11 applies to any misleading statements that appear in a prospectus. Section 11 does not require the plaintiff to prove fraudulent intent, or even negligence, on the part of the defendant. In order to balance the harsh, strict liability features of Section 11, Congress expressly has limited the damages to those directly caused by the defendant's misleading conduct. The remedy and the loss causation defense are provided by statute, and stand in stark contrast to the judge-made remedy for Rule 10b-5 violations.

For the above reasons, the court does not change its holding that Deloitte was entitled to summary judgment upon a showing that its alleged accounting errors never were disclosed to the market.

B. *Whether Deloitte's Alleged Errors Were Disclosed*

Of course, it is not necessary for Deloitte to admit publicly that it made errors in the Debenture Prospectus for the jury to find disclosure of the errors to the market. The market could have learned of Deloitte's errors indirectly through the disclosure of related information. Here, plaintiffs contend that the errors in WOW's 1987 financial statements in fact were disclosed to the market before plaintiffs filed this suit. Plaintiffs argue that WOW's public disclosure of adverse information shortly

after the debenture offering clued in the market to Deloitte's alleged overstatement of WOW's fiscal 1987 revenues.

After the debenture offering, WOW publicly disclosed information that adversely affected the price of the debentures. Specifically, WOW disclosed that it ran out of cash in the middle of fiscal 1988, due in part to declining sales, and in part to inability to collect past due accounts receivable. Plaintiffs contend that the market must have learned of Deloitte's overstatement of WOW's fiscal 1987 revenues from these disclosures.

The court fails to see the logic in plaintiffs' argument. The amount of revenue posted by a company during a prior year is a number that exists only on paper to reflect total sales during that year. The amount of actual cash the company has access to at the moment is not necessarily related to its total sales in the previous year. This is a separate issue, and investors are savvy enough to look in places other than the company's statement of revenue to find out the relevant facts on the company's immediate access to cash.[7] The market would not interpret WOW's running out of cash as a signal that its revenues for the previous year were overstated.

Moreover, even if WOW's lack of access to cash was related to Deloitte's alleged mistake, the Debenture Prospectus truthfully disclosed all the relevant facts on

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[7] A company's liquidity, or immediate access to cash, is evidenced by factors other than total sales, such as the company's ability to collect accounts receivable and the amounts of cash available on existing bank credit lines. It is common for a company to disclose these factors in a prospectus.

WOW's continued liquidity elsewhere in the Debenture Prospectus. (Order at 866.) The Debenture Prospectus clearly warned that WOW's access to capital in the near future was suspect. It disclosed that WOW's existing bank credit lines were tapped nearly to the limit, and that the company would be severely damaged by an anticipated shortfall in demand. *Id.* In short, the risk that WOW would run out of cash was a risk that WOW's investors assumed when they purchased the debentures. Deloitte is not liable for the losses plaintiffs incurred when this possibility became reality.

Plaintiffs present no other evidence of any disclosure from which the market possibly could have gleaned that Deloitte's statement of WOW's fiscal 1987 revenues was in error. The court considered the merits of Deloitte's defense in its Order. Viewing the evidence in the light most favorable to the plaintiffs, this court held that "[t]here was no disclosure of [Deloitte's alleged accounting errors] to the public at any time before this lawsuit was initiated." (Order at 866-67.) Thus, as explained above, these alleged errors could not have affected the market price of WOW's debentures. Deloitte is not liable under Section 11 for any part of plaintiffs' losses.

C. *Plaintiffs' Rule 10b-5 Claims*

This court granted summary judgment in favor of Deloitte on plaintiffs' Rule 10b-5 claim on the ground that, as a matter of law, plaintiffs' evidence did not establish scienter on the part of Deloitte. (Order at 870-71.) Plaintiffs ask the court to reconsider this holding.

Plaintiffs argue that "[t]he Order inexplicably dismisses Mr. Rossi's exhaustive, highly detailed, 81-page declaration as 'conclusory' and unaccountably disregards plaintiffs' other evidence." (Plaintiffs' Mem. at 23.) The court did not disregard any evidence presented by plaintiffs. On the contrary, it held that plaintiffs' evidence, even when viewed in the light most favorable to plaintiffs, did not have enough probative value to rebut Deloitte's evidence showing a lack of scienter. Not all of plaintiffs' evidence was worthy of comment in the court's Order. Plaintiffs' motion to reconsider on this issue is denied.

As to Rossi's declaration, the number of pages submitted to the court has nothing to do with the weight the evidence is entitled to. As the court held, "Rossi's opinion is not based on specific facts that shed light on the mental state of Deloitte's auditors, and from which the jury on their own could infer scienter. Rather, Rossi is drawing his conclusion based on a record that conclusively rebuts any inference of scienter." (Order at 870-71.)

Plaintiffs' evidence and arguments on this issue have already been considered by the court. Their motion to reconsider is denied.

IV. CONCLUSION

In accordance with the foregoing, plaintiffs' motions to reconsider the court's January 20, 1993 Order and entry of judgment are DENIED.

IT IS SO ORDERED.

No. 95-154

Supreme Court, U.S.
FILED
SEP 11 1995
CLERK

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of *Certiorari* To The United States Court Of Appeals For The Ninth Circuit

PETITIONERS' REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI*

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Petitioners Rosetta Miller *et al.* (the "Investors") submit this Reply Brief in support of their petition for a writ of *certiorari* to review the Ninth Circuit's decision in *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407 (9th Cir. 1994) ("*WOW II*").

I. A WRIT OF CERTIORARI SHOULD BE GRANTED ON THE ISSUE OF AUDITOR *SCIENTER* UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 ("SECTION 10(b)")

A. The Ninth Circuit's Rulings Regarding Auditor *Scienter* Constitute a Radical and Dangerous Departure from Settled Law Under Section 10(b), and Require Review By This Court

The Ninth Circuit's rulings regarding the legal standards for determining an auditor's *scienter* under Section 10(b) require review by this Court because they depart drastically from settled law and threaten the integrity of securities markets. The arguments made against review by respondent Deloitte & Touche LLP ("Deloitte") are uniformly without merit. First, Deloitte contends that the Ninth Circuit's decision reflects nothing more than a determination that the Investors' factual showing was inadequate. However, this contention is incorrect. The Ninth Circuit criticized the Investors' evidence, but only because that evidence did not satisfy the erroneous legal standard for auditor *scienter* which the Court adopted. There was nothing wrong with the Investors' evidence – under a proper legal standard, it would have been held to be more than sufficient to establish the existence of triable issues of fact regarding *scienter*. The Ninth Circuit's adoption of an inappropriate legal standard should be reviewed by this Court.

Deloitte further argues that granting the writ would embroil this Court in narrow factual disputes of little relevance to other cases. However, this assertion is incorrect. Indeed, contrary to Deloitte's contention, the two *key* facts regarding Deloitte's *scienter* – the material falsity of the financial statements and Deloitte's contemporaneous

knowledge of the facts which rendered them false – were undisputed in the Ninth Circuit, and they are undisputed here. These two facts – falsity and knowledge – were sufficient to establish a *prima facie* case of *scienter* under settled law.[1]

Yet, the Ninth Circuit held that proof of falsity and knowledge does not even raise a *jury question* regarding *scienter*. *WOW II*, 35 F.3d at 1426. Rather, the Court held that *scienter* is lacking as a matter of law, irrespective of the defendant's knowledge or intent, unless the plaintiff proves

> . . . that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted by the same facts.

WOW II, 35 F.3d at 1426 (quoting *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)). The adoption of the *Price Waterhouse* test as the exclusive standard for auditor *scienter* was grievous legal error. All other courts of appeals which have addressed the issue have held that proof of intentional, knowing or reckless conduct satisfies the element of *scienter*. *See* Investors' Petition, at 20-21. Paradoxically, under the Ninth Circuit's *Price Waterhouse* standard, *only* reckless conduct suffices for liability.[2]

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[1] *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (Section 10(b) proscribes knowing misrepresentations). *See also* cases cited in the Investors' Petition, at 20-21.

[2] Deloitte does not even try to defend the proposition that the only way to prove *scienter* is to satisfy the *Price Waterhouse* recklessness test. Instead, Deloitte denies that the Ninth Circuit intended the *Price Waterhouse* standard to be the exclusive test for *scienter*. Deloitte Br. at 8-9 n.5. According to Deloitte, the Ninth Circuit relied on a recklessness test because it found that the Investors introduced no "direct evidence" of Deloitte's

Deloitte also disputes the Investors' contention that making a false statement with knowledge of the facts which render it false is sufficient to raise triable issues regarding *scienter*. Rather, Deloitte argues that to defeat summary judgment on the issue of *scienter*, a Section 10(b) plaintiff must show not only that the defendant made the statement and knew the facts which rendered the statement false, but also that the defendant knew the falsity of the statement. Deloitte Br. at 10 n.6. To the extent that this argument is comprehensible, it is wrong. Knowledge of the facts which render a statement false *is* knowledge of the statement's falsity.[3] At a minimum, it raises triable issues of fact with respect to falsity.[4] Indeed, it is unclear how a plaintiff could do more to establish the existence of a triable issue of fact on the issue of *scienter* than to prove that the defendant made a false representation despite his knowledge of the facts which rendered it false.[5] To

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knowledge. *Id.* However, Deloitte's argument mischaracterizes the Ninth Circuit's analysis. The Court *explicitly* held that proof of knowing or even deliberate misrepresentations does not establish *scienter*, and that satisfaction of the *Price Waterhouse* recklessness test is a prerequisite for section 10(b) liability. This novel ruling should be reviewed by this Court on *certiorari*.

[3] *See, e.g., Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976) (trial verdict for plaintiff affirmed where auditor "had actual knowledge of the omitted facts which rendered its report misleading").

[4] *E.g., Endo v. Albertine*, 863 F. Supp. 708 (N.D. Ill. 1994) (expert accounting testimony that auditor knowingly failed to disclose material information raised an inference of *scienter*).

[5] Here, for example, plaintiffs showed that Deloitte approved revenue recognition on massive, end-of-year transactions. SEC Rules and Generally Accepted Accounting Principles required the transactions to satisfy seven conditions to merit revenue recognition. The evidence – not only the declaration of accounting and auditing expert Albert Rossi but the actual contracts for the transactions – established that the transactions failed to satisfy at least *five* of the seven conditions. Deloitte had

require more would be to insist on proof of a subjective intent to defraud, which no court has required as a condition of establishing *scienter.*

B. The Ninth Circuit Improperly Held that Where Expert Witnesses Disagree Regarding the Validity of an Auditor's Accounting Determinations, the Auditor Is Entitled to Summary Judgment

The Ninth Circuit improperly held that a Section 10(b) plaintiff cannot defeat an auditor's summary judgment motion if the auditor submits expert testimony attesting to the reasonableness of its accounting determinations. Deloitte disputes this reading of the *WOW II* opinion. However, Deloitte's reading is not only incorrect but is itself so troubling that this Court should grant review.

According to Deloitte, the Ninth Circuit held only that "the trial court was not required to defer to the nonmovant's expert testimony on summary judgment when the evidence in support of the moving party is *otherwise clear.*" Deloitte Br. at 11 (emphasis added). However, this interpretation of the Ninth Circuit's ruling is wrong. The Court's conclusion that Deloitte's evidence "negated" the Investors' attempt to establish *scienter* is followed directly in the *WOW II* opinion by a quotation from *Price Waterhouse, supra,* to the effect that where "complex issues of accounting" are in dispute, and experts on both sides present "diametrically opposing views", "no finding of fraud or recklessness can rationally be made . . . " 35 F.2d at 1426.

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the contracts, reviewed them and was aware of the terms of the deals. The auditors were also obviously chargeable with knowledge of the relevant accounting rules and principles. What more could a plaintiff show to establish knowledge of the falsity of the audited financial statements?

Thus, the Ninth Circuit held that Deloitte's evidence "negated" the Investors' evidence not because the record was "otherwise clear", but because the Court believed "no finding of fraud or recklessness [could] rationally be made" due to the presence of conflicting expert declarations reflecting "diametrically opposing views". This revolutionary and dangerous holding merits review by this Court.

Even if Deloitte's interpretation of the Ninth Circuit's opinion is correct, and the Court has merely held that the plaintiff's evidence on summary judgment may be ignored where the evidence is "otherwise clear", the ruling must be reviewed. Contrary to Deloitte's contention, no case prior to the *WOW II* opinion has held that evidence submitted in opposition to a summary judgment motion may be disregarded under Rule 56 merely because the evidence submitted by the *moving* party is "otherwise clear". No matter how "clear" the moving party's evidence may be, summary judgment may not be granted where the opposing party has submitted evidence which, if credited by the trier of fact, would support a verdict in the nonmoving party's favor at trial. *Eastman Kodak Co. v. Image Technical Services*, ___ U.S. ___, 112 S.Ct. 2072 (1992).[6]

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[6] In support of the proposition that courts are free to disregard expert testimony on summary judgment, Deloitte and the Ninth Circuit rely on *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1116 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). However, *Apple* is inapposite. In *Apple*, the expert's declaration concerned a matter so within the common experience of jurors that a jury could make up its own mind without expert guidance. Here, nobody claims that accounting and auditing are subjects a reasonable juror would know about. Expert testimony is necessary and it cannot be disregarded simply because it conflicts with the opinion of the other side's expert witness. The other cases cited by Deloitte on this point (Deloitte Br. at 14-15) are similarly distinguishable – none of them involved expert testimony disregarded by a court simply because it conflicted

C. The Ninth Circuit's opinion Conflicts with the Opinions of other Circuits

The *WOW II* opinion holds that even proof of intentional or knowing material misrepresentations, without more, cannot prove an auditor's *scienter* – only proof of a certain type of recklessness is sufficient, under the Court's interpretation of the *Price Waterhouse* test. In so holding, the opinion directly conflicts with the holdings of other circuits (and the opinion of this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)) that proof of intentional or knowing misstatements *does* satisfy the *scienter* requirement. *See* Investors' Petition, at 20-21. Deloitte's attempt to rebut the existence of this conflict (Deloitte Br. at 12) focuses only on the illusory distinction between knowledge of facts which render a statement false and knowledge of the falsity of the statement. Deloitte does not grapple with the fundamental contradiction between the holdings of other circuits that knowledge or intent are sufficient to prove *scienter* and *WOW II*'s holding that knowledge and intent are *insufficient*.

An additional conflict between the circuits requires review by this Court – the conflict between the Ninth Circuit's holding that there can be no *scienter* where an auditor submits expert testimony in support of the reasonableness of his accounting determinations and the holdings of other circuits that conflicting expert testimony precludes summary judgment.[7] Deloitte argues that

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with the testimony of the opposing party's expert. Moreover, Deloitte cites not a single case which suggests that a court can disregard the comprehensive *non-expert* evidence of *scienter* submitted by the Investors here, including Deloitte's own *concession* that it knew the facts which rendered the financial statements false, but nevertheless certified them and disseminated them notwithstanding that knowledge.

[7] Even outside the accounting context, other circuits have held that summary judgment is unavailable where the nonmoving party contests the moving party's showing by submitting

there is no conflict because the plaintiffs in the cases cited by the Investors presented other evidence in support of *scienter* in addition to expert testimony. However, this does not negate the existence of a conflict. First, there was ample non-expert evidence of *scienter* presented here, too, all of which the Ninth Circuit disregarded.[8] Furthermore, the fact that the courts in the cases cited by the Investors also looked at non-expert evidence does not alter their holdings that competent, admissible expert testimony precludes summary judgment in favor of an auditor defendant under Section 10(b). For example, in *Fine v. American Solar King*, 919 F.2d 290, 297 (5th Cir. 1990), *cert. dismissed*, 502 U.S. 976 (1991), the Fifth Circuit held that an expert declaration similar to Mr. Rossi's "suffice[d] to create a triable issue" on an auditor's *scienter*. Similarly, in *Endo v. Albertine, supra*, 863 F. Supp. at 728 n.41, the Court denied an auditor's summary judgment motion on the issue of *scienter* based on the testimony of the plaintiff's expert witness.

Finally, Deloitte purports to distinguish *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), on the grounds that the Court relied principally on other evidence to establish criminal intent in a prosecution for disseminating false financial statements. However, the fact remains that in *Simon*, a jury verdict was upheld despite conflicting expert testimony regarding the *reasonableness of the auditors' accounting determinations*. Under *WOW II*, that verdict would have been

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the declaration of a qualified, competent expert. *Ambrosini v. LaBarraque*, 966 F.2d 1464, 1470-71 (D.C. Cir. 1992); *Hughes v. American Jawa, Ltd.*, 529 F.2d 21 (8th Cir. 1976).

[8] Deloitte relies on the Ninth Circuit's statement that the Investors did not introduce any "direct" evidence of *scienter*. However, as this Court has cautioned, direct evidence of a defendant's state of mind is seldom available, and therefore, proof of *scienter* must often be a matter of inference from circumstantial evidence. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 (1983).

reversed. Thus, there is a conflict requiring this Court's intervention.

II. A WRIT OF CERTIORARI SHOULD BE GRANTED TO REVIEW THE NINTH CIRCUIT'S RULINGS REGARDING THE "BESPEAKS CAUTION DOCTRINE", NON-AUDITOR *SCIENTER* AND SUMMARY JUDGMENT STANDARDS UNDER FED. R. CIV. P. 56

A writ of *certiorari* should also be granted to review the Ninth Circuit's rulings regarding the "bespeaks caution doctrine" and the *scienter* of the Officer, Director and Venture Capitalist defendants, as well as the Ninth Circuit's denial of the constitutional right to a jury trial through the misapplication of summary judgment standards.

A. The "Bespeaks Caution Doctrine"

The Respondents contend that the writ should be denied as to the "bespeaks caution doctrine" because the Investors challenge only the Ninth Circuit's "application (not adoption)" of that doctrine. This argument lacks merit. While many lower courts have adopted something they have called the "bespeaks caution doctrine", there is no general agreement regarding what that "doctrine" means or how it is to be applied.[9] The Ninth Circuit in *WOW II* has applied the "doctrine" in a fashion which conflicts with this Court's teachings regarding materiality and adequacy of disclosure, and which controverts the rulings of other circuits regarding whether "risk disclosures" can render immaterial misrepresentations of existing facts. The question of the applicability of the "bespeaks caution doctrine" is of great importance to the

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[9] *See, generally,* D. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus. Law. 481 (1994) (distinguishing between various versions or interpretations of the "doctrine").

securities markets. Issuers of securities, investors and regulators all require this Court's guidance regarding the scope and limits of the "bespeaks caution doctrine". Notwithstanding the Respondents' contrary contentions, the issue is fairly presented on this record. Accordingly, a writ should be granted to review this issue.

B. Non-Auditor *Scienter*

The Respondents contend that the issue of *scienter*, in the context of the Investors' Section 10(b) claims against the Officer, Director and Venture Capitalist defendants, is not suitable for review because the Ninth Circuit's grant of summary judgment on this issue was based on a failure of proof by the plaintiff, not on a ruling that the defendants' evidence demonstrated an absolute bar to liability. However, the Respondents are wrong. There was no failure of proof – the Ninth Circuit granted summary judgment to the Officers, Directors and Venture Capitalists because it found that these defendants' "overall pattern of conduct rebuts any inference of *scienter*". *WOW II*, 35 F.3d at 1424, 1427-28.[10] The factors which the Court held conclusively rebut *scienter* cannot do so, as a matter of law. *See* Investors' Petition, at 27-29. Thus, this issue merits review by this Court.

C. Summary Judgment Standards

The Respondents argue that review of the Ninth Circuit's application of summary judgment standards is inappropriate both because the Ninth Circuit applied the correct summary judgment standards and because the Ninth Circuit's treatment of the issue will not affect other cases. They are wrong on both counts. In disregarding

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[10] The Ninth Circuit stated that the Investors had not presented "direct" evidence of the Officers', Directors' and Venture Capitalists' *scienter*. However, as noted above (*see supra*, n.8) this Court has held that *scienter* need not be, and often cannot be, proven by "direct evidence".

substantial evidence submitted by the Investors, weighing that evidence against the evidence submitted by Respondents and declining to extend legitimate inferences in favor of the Investors, the Ninth Circuit acted in a manner inconsistent with the Rule 56 standards promulgated by this Court, and in violation of the Investors' constitutional right to a jury trial. Moreover, the issue of how the standards of Rule 56 are to be applied consistent with constitutional and due process guarantees is of significant importance to the administration of justice in the federal courts. Review should be granted on this issue.

III. CONCLUSION

For the foregoing reasons, a writ of *certiorari* should issue to review the opinion below.[11]

Respectfully submitted,

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[11] Respondent Smith Barney argues that the writ should be denied as to it because the Investors conceded, or waived their right to appeal with respect to, two issues regarding Smith Barney's liability for the alleged misrepresentations and omissions in the "textual" (*i.e.*, non-financial-statement) portions of the Prospectus – Smith Barney's "due diligence" defense under Sections 11 and 12(2) of the Securities Act of 1933, and Smith Barney's contention that it lacked *scienter* under Section 10(b). Smith Barney Br., at i, 1, 3-4, 6. Smith Barney further represents to this Court that the lower courts ruled in its favor on both of these issues. SB Br., at 6-7. These contentions are both untrue and irrelevant to the Investors' Petition.

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